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MAJOR TAX REFORM OPTIONS

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

AUGUST 7 AND 9, SEPTEMBER 11 AND 20, 1984

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MAJOR TAX REFORM OPTIONS

TUESDAY, SEPTEMBER 11, 1984

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 10:04 a.m. in room SD-215, Dirksen Senate Office Building, Hon. John Danforth presiding.

Present: Senators Dole, Danforth, Packwood, Heinz, Roth, Long, and Boren.

[The press release announcing the hearing follows:]

[Press Release No. 84-165, Aug. 13, 1984]

FINANCE COMMITTEE ANNOUNCES NEW ROUND OF TAX REFORM HEARINGS FOR SEPTEMBER

Senator Bob Dole (R. Kansas), Chairman of the Committee on Finance, announced this afternoon that the Committee would schedule another round of tax reform hearings when Congress returns from recess in September.

The hearings will be held on Tuesday, September 11, 1984, and Thursday, September 20, 1984, beginning each day at 10:00 a.m. in Room SD-215 of the Dirksen Senate Office Building.

Senator Dole made the announcement upon the conclusion of 2 days and some 7 hours of hearings on tax reform options here last week. Four United States Senators—William V. Roth, Jr. (R., Delaware), Bob Kasten (R., Wisconsin), Mark O. Hatfield (R., Oregon) and Dan Quayle (R., Indiana)—and 29 witnesses from the private sector submitted testimony during the hearings last Tuesday and Thursday.

The hearings held last week, as well as those scheduled for September, focused on proposals which have been set forth for a flat-rate income tax, or for a simplified income tax with lower rates and fewer exceptions from the tax base, and on alternative suggestions such as a value-added tax, a national sales tax, a tax based on consumption rather than income, or a gross income tax.

Senator Dole noted that over 30 other witnesses from the private sector already had requested to testify at the September hearings, along with numerous members of the House of Representatives.

"In September of 1982, the Committee on Finance began an examination of flat-rate and other major tax reform proposals," Senator Dole said. "This is an issue that has attracted considerable attention since our action in 1981 to reduce tax rates across the board, and the measures to broaden the tax base that have been undertaken since then. There seems to be a growing consensus that lower tax rates coupled with a broader tax base, or a tax based on consumption in some form, could be fairer to the taxpayer as well as better for the economy."

Senator Dole indicated that the Committee on Finance would examine the details of substantive proposals that have been made, and in September will receive additional testimony on alternative tax proposals to achieve the goals of greater equity, simplicity, balance and economic efficiency in the tax system.

Senator DANFORTH. Senator Dole is at the White House right now, and has asked me to sit in for him, which I am pleased to do.

The first panel: David A. Berenson, partner of Ernst & Whinney, Washington, DC; and Norris Farnell, CPA, Skaggs & Farnell, Texarkana, TX.

Are they here?

STATEMENT OF DAVID A. BERENSON, PARTNER, ERNST & WHINNEY, WASHINGTON, DC

Mr. Berenson. Thank you. Good morning, gentlemen. I am David Berenson. I'm the partner in charge of the Washington National Tax Service for Ernst & Whinney. And I thank you for the opportunity to present our views here.

There seems to be this growing consensus that lower tax rates, coupled with a broader tax base, possibly including a type of revenue raising consumption flat tax, would be fairer to the taxpayer and better for the economy. However, to achieve this, I think there are three misconceptions regarding the concept of complexity-simplicity that are present in our present system that have to be addressed. Basically, the first is the belief that the current income tax system has always been overly complex.

No. 2 is that a revenue neutral flat tax concept would simplify the tax law. And that third the public perception, whether it's reality or not, that their total taxes—Federal, State, and local—under a flat or othere simplified tax reform would be revenue neutral or would actually decrease.

I think those are the three misconceptions that must be addressed.

With respect to the first one, namely the belief that the current income tax has always been overly complex, until the system was buffeted by the twin devils of inflation and high interest rates, such was not always the case. There are complex provisions, but for the vast majority of taxpayers, they were not applicable.

For those taxpayers who typically report wages or minimal passive income, the system was not too much more complex than was necessary. Therefore, any change that we are talking about would have to be two-pronged. The two-pronged is the concept of further reform and simplification, and the second prong has to be solely revenue raising, which is the one that is probably directed at the concept of the consumption or value added taxation.

Complex tax provisions are frequently necessary to assure appropriate taxation of complex business transactions and will remain with us. There is almost a circular irony involved here in that legislative attempts seeking equity create complexity which in turn leads to negative perceptions of the equity of our system.

This, in effect, leads to attempts to legislate greater equity that results in even greater complexity. Even the introduction of certain simplifying legislation, such as the zero bracket amount, has produced change over complexity, leading to a staggering volume of interpretative authority and a lack of interpretative authority. As I have indicated before—I think there are approximately 400 interpretative projects, some going back to 1969 that are still pending. Probably 200 more coming from the 1984 Tax Act. And this further concept of what I call transition shock will also create greater complexity.

The concept of neutrality, in effect, has never really been fully defined, and in many cases will prove illusory. Obviously, we have focused on situations like the poor little rich boy who receives $15,000 from the father's trust fund. Should he be taxed the same amount as the steel laborer who receives $15,000? Should we, in effect, eliminate the dependent child care credit? The two wage earner benefits, and so forth?

Even at this early stage of deliberation, under the simplified proposals, there seems to be a political consensus developing with respect to retention of the deduction for mortgage interest and similarly with respect to charitable contributions. So when we get through, the concept that just because we have a so-called simplified or flat tax that it will be less complex is not realistic we have found that just the mere utilization of the tables—and there will probably be more tables under some of these proposals than we even have now—would also be complex.

As to the concept of neutrality among varying individual and broad income groups, we find that there will be significant increases and decreases which inevitably will result within these various groups. And as I mentioned before, once you start using tax tables, which must come into any of these new proposals, you will find that the system will be complex.

The last area that I think is very important is this public perception that total taxes in the simplified or reform area, as contrasted to the revenue raising VAT consumption tax, on a Federal, State, and local level, would be revenue neutral or decrease The pitfall that we face here is a reverse revenue sharing, especially in States where there is high income, high property, and high sales taxes. That impact is very, significant.

For example, if we assume that the Federal reform measures, in effect, remain constant in their revenue affect and neutral, and you would retain the same Federal tax dollars across the board—and if we assume that the State and local jurisdictions also must retain their total tax dollars across their board for their revenue needs, in effect, you can have the situation where the tax burden will increase. For example, if a specific body of citizens are paying a tax in state and local jurisdictions of $10 billion and because of a simplified flat tax—the indirect Federal subsidy is eliminated their out-of-pocket costs for State taxes actually increases potentially upwards to 50 percent. After we get through with reducing or eliminating the deductions for property sales and income taxes, the net cost to them of such taxes increases substantially, although you have achieved Federal and State neutrality in the overall revenue package. If State taxes increase because of base broadening under Federal definitions, the after-tax impact becomes even greater.

You will have increased the tax burdens on the individual State taxpayers substantially. Now apart from the merits of removing the Federal subsidy ingrained in our State tax structure, the perception out there is that a flat, simple reform package will not cost them more. When you combine the foregoing with the impacts on the State and local jurisdictions of the increase in interest rates and borrowing costs that they must undertake to have their obligations yield the same after tax effect at a lower effective tax rate, you can have some very significant adverse State impacts.

In closing, I would again urge the same care as for example, when we carefully reformed the Bankruptcy Tax Act without undue political haste. I would suggest an economic environmental impact study on the broad spectrum of some of these proposed changes, providing enough time to come back and see not only the potential tax impact, but the possible economic impact as to what some of these changes will create outside the Federal tax system. Thank you.

Senator **DANFORTH**. Thank you.

[The prepared written statement of Mr. Berenson follows:]

Prepared Statement of Ernst & Whinney, Presented by David A. Berenson

SUMMARY OF STATEMENT

I am David A. Berenson, Partner in Charge of Washington Tax Services for the international accounting firm of Ernst & Whinney. Thank you for the opportunity to appear at this hearing. I have several comments on the reform of our tax system.

1. Interaction of Complexity and Equity. Many tax reform measures have been proposed because of the perceived complexity and inequity of our present system. While some of these perceptions obviously reflect reality, the public nevertheless has many misconceptions of how the income tax system operates. Complexity arises from attempts to legislate precise interpretations, legislate in specific detail, close "loopholes," provide necessary transition rules, and use the tax system to attain social and economic objectives. A circular irony exists in that tax complexity leads to negative perceptions of the equity of our system, which then leads to attempts to legislate greater equity that results in even greater tax complexity.

2. Reform Proposals Have Problems. The current flat-tax proposals, although superficially appealing, ultimately will be perceived by many taxpayers as being less "fair" than the existing system. Further, the flat tax goal of extreme simplicity is unrealistic in our complex society, and the circular consequence of promoting equity applies to the flat-tax proposals as well as to our present system. In a similar manner, consumed-income tax proposals suffer from problems of design, measurement, equity, administration and compliance, and especially of transition.

3. Economic Impact Statement. Any major restructuring of the tax system should be preceded by an "economic impact analysis" of the potential change, including the probable consequences for financial markets, business decision making, tax administration and taxpayer behavior.

4. Increased Public Education. The Administration and Congress should make a commitment to a broad-based program for educating the public about the tax system. Public opinion polls reveal general misperceptions about the tax system, particularly with respect to the tax burden on high-income individuals. These misperceptions have contributed to the decline in public confidence in and support for the current income tax. Greater public education about the tax system by using the media is needed to combat the self-fulfilling perception of widespread noncompliance. In addition, public debate on fundamental tax reform will be more meaningful if there is greater awareness of how the current system is functioning.

5. Target Communications at Typical Taxpayers. The Congress and Administration should make a commitment to educating the public on tax benefits and the reporting requirements that are applicable to average individual taxpayers. In addition, there is a need to educate the public on the relative ease with which Form 1040EZ and Form 1040A can be prepared.

6. Emphasis of Press Releases. Government press releases to the media should focus more on how well the system works. Much of the perception of noncompliance may arise from misinterpreted government press releases. By emphasizing breakdowns in the tax system, the government may be contributing to the decline in public support and confidence in the present income tax.

7. Improving the Audit Process. Increased appropriations should be made to improve the audit process. An attempt should also be made to provide an examination rate which cost-benefit analysis indicates will optimize taxpayer compliance; the costs considered in this analysis should include the costs to both taxpayers and the government. Government information releases concerning tax audits should emphasize improvements in selecting returns for audit rather than the decline in the percentage of returns audited.

8. Reinstitute the District Conference. A District Conference would improve the Service's dispute resolution mechanism and improve taxpayer confidence in the system by providing an earlier, less formal setting for reviewing disputes. Accordingly, a District Conference should be instituted, at least for most small cases.

9. Creation of a National Tax Reform Commission. A national commission, composed of representatives of Congress, the Administration, tax professionals and taxpayers, should be created to review and offer proposals on federal income tax reform. The commission should be assigned the task of studying reform proposals and submitting its own proposals, including appropriate transition rules, within three years of its formation, with a view toward implementation in five years.

10. Scope of Commission Inquiry. The commission should take a broad view of all suggestions for reform and simplification. For example, Ernst & Whinney has proposed a Deemed Capital Transaction approach to partial integration of corporate-shareholder taxation. This proposal reduces complexity by reducing the tax differences in the treatment of dividends, stock redemptions and liquidations. It is a concept meriting consideration.

11. Task Force Assistance. The commission should establish task forces to review and offer targeted proposals on specific areas of concern. Some topical areas for consideration include: revisions in information reporting; uniformity of rules in areas of common application; compliance-oriented measures directed at the cash economy; monitoring compliance with disallowance provisions; and increasing the use of objective rather than subjective standards for tax determinations.

12. Moratorium on Substantial Tax Changes. Until the commission's reform proposals have been submitted and their implementation considered, the Congress and Administration should agree to a moratorium on substantial structural changes in the income tax law.

INTRODUCTION

We welcome the opportunity to appear at these hearings. We are encouraged by the commitment that this Committee is making to consideration of broad-based tax reform legislation. The contemplative process you are undertaking in this forum has been sorely needed for years.

Senator Dole has stated that, "These hearings should serve to open a highly significant debate over the direction of tax policy next year and in the years ahead, and there are many difficult questions that need to be answered." We agree, and will focus our testimony on a few of these questions. Specifically, we have limited our attention to taxation measured by income and will not discuss matters relating to excise taxes or estate and gift taxes. Further, our discussion of consumption-oriented taxes will be limited to a consumed-income tax. Although a national retail sales tax or a value-added tax are consumption taxes and may represent tax reform, they are viewed mainly as candidates for revenue raising and thus will not be discussed in this testimony.

The federal income tax has existed for approximately 70 years. For the better part of this period it has been a fair, effective and well accepted means of financing the government. Over the past 10 years, however, it increasingly has been perceived by taxpayers to have become less effective and as a result appears to have declining public support.

We feel that much can be done with the current income tax system to restore it to a position of being the paradigm for a fair, well accepted method of raising federal revenues. Thus, this testimony does not discuss the adoption of radically new systems of taxation, but rather how the existing system might be significantly changed to better attain its goals.

We are deeply concerned that if taxpayer confidence in the revenue system is as low as the media would have us believe, there will probably be few chances to reform it and any such reform will need to be carefully considered.

MISCONCEPTIONS RELATING TO COMPLEXITY/SIMPLICITY IN THE INCOME TAX SYSTEM

Is The Current Income Tax System Unnecessarily Complex?

Many taxpayers file simple returns. It is clear that there are many complex provisions in the Code. However, in 1983 more than 35 million taxpayers (nearly 40 percent of all individual returns) filed either a Form 1040EZ or a Form 1040A. In order to qualify to file these 1983 returns a taxpayer must have met the requirements in Table I.

Clearly, the income tax law is not unnecessarily complex for these more than 35 million taxpayers plus those millions who do not have to

Table I

Difference in Filing Requirements

Form 1040EZ	Form 1040A
Filing status: Single only	**Filing status:** Single Married Filing Jointly Married Filing Separately Head of Household
Number of exemptions: Only one personal exemption	**Number of exemptions:** All exemptions that the taxpayer is entitled to claim
Only taxable income of less than $50,000	**Only taxable income of less than $50,000**
Only income from: Wages, salaries, tips Interest of $400 or less	**Only income from:** Wages, salaries, tips Interest Dividends Unemployment compensation
No itemized deductions May deduct a part of some amounts given to charitable organizations	**No itemized deductions** May deduct a part of some amounts given to charitable organizations
No adjustments to income	**Adjustments to income for:** A deduction for a married couple when both work and a deduction for payments to an IRA
No other taxes	**Other taxes:** Advance EIC payments
No tax credits	**Only tax credits for:** Partial political contributions credit Credit for child and dependent care expenses Earned income credit

file a tax return because their gross income does not exceed the filing threshold. In addition, many other taxpayers are required to file Form 1040 each year solely because they have relatively simple adjustments, e.g., moving expenses, alimony payments or itemized deductions. The tax rules relating to these items have not changed appreciably in many years and are generally understood by the taxpayers to whom they apply.

Changing nature of business transactions. Our economy is complex. There are many nontax-motivated transactions that occur now but which were either not contemplated or uncommon 30 years ago. For example, financial instruments containing inflation hedges or production incentives have been created in the last several years. Complex business transactions often result in new tax provisions to assure appropriate taxation. Thus, tax provisions may be enacted, for instance, to curtail the use of certain business transactions or their being used in a manner solely to obtain tax benefits.

In addition, as previously uncommon transactions become more common, complex legislative responses frequently arise. Generally, these legislative responses affect only a few taxpayers, e.g., Section 341, which pertains to collapsible corporations.

The Problem of Complexity

The role of certainty. Some 200 years ago, Adam Smith proposed that taxes "ought to be certain not arbitrary." The federal income tax should not be a capricious system. The standard of certainty is necessary in the operation of the federal tax system for two reasons. First, certainty enables the tax system to be understood, permitting taxpayers to plan financial affairs with an awareness of their tax implications. Second, certainty is essential in preserving taxpayer morale and thereby strengthening voluntary compliance.

The present degree of certainty is less than ideal. Conflicts frequently arise between certainty and other tax system standards or goals. These conflicts primarily result from the degree of complexity created in furtherance of equity and fairness coupled with certainty within the tax system.

The number of rules embodied in the Code and its interpretations has experienced a many-fold increase during the last 30 years. This proliferation of complexity has been in pursuit of at least five objectives:

- Attempting to increase certainty by making tax laws more exacting so their interpretations are more precise;

- Striving to create a more equitable system by providing detailed specifications for income, deductions, exemptions and credits, many of which require new code sections or expanded versions of old ones;

- Attempting to close actual or perceived "loopholes" that do not advance the purpose of the Code provisions with which they are associated or that enable transactional tax benefits beyond those intended or deemed appropriate;

- Providing transition rules for new provisions to allow taxpayers who relied upon prior law ample time to adjust their affairs; and

- Striving to attain social and economic objectives by creating incentives or disincentives within the tax system.

The circular consequence of promoting equity. Creating a more equitable system, the second objective resulting in additional complexity, is particularly troublesome. Complexity seems to breed distrust of the system by individual taxpayers, especially those who cannot afford expert tax advice. Distrust may well be a consequence of not understanding the tax system. Furthermore, lack of understanding also seems to affect negatively perceptions of the fairness of our tax system, a conclusion supported by the findings in the Roper Survey mentioned later in this testimony.

To summarize, complexity is, in part, a by-product of attempts to promote equity. But in fact, complexity has led to a misunderstood tax system that is perceived as inequitable. Successive attempts to further equity result in the perception by taxpayers that this goal is not being realized. As a result, taxpayer morale and compliance have declined.

If a complex tax system is not understandable, then a simple one would appear to be the solution. For example, a simple system in the form of a proportional tax on annual gross receipts would, at first glance, be readily accepted. Its simplicity makes it understandable. Nevertheless, it would probably soon be characterized as unfair because of the inequities produced.

Tax policymakers are therefore in a quandry: complex systems are not understandable and are thus perceived as unfair, and yet simple systems, which are understandable, may also be considered unfair. Obviously, there must exist some middle road that actually simplifies the existing system while optimizing its inherent and perceived fairness.

Would A Flat Tax Simplify the Tax Law?

A pure flat tax reaching all income that constitutionally may be taxed could be quite simple. While simplistic in its approach, however it might ultimately prove complex in application, especially in attempting to avoid unacceptable regressivity and loss of equity. In formulating a flat tax, therefore, simplicity in broad detail will most likely yield to increased fairness (generating complexity) when reduced to the specific detail of actual operation.

In any event, a pure flat tax is probably politically impossible to enact. For instance, even at this stage of considering flat-tax proposals, there appears to be a political consensus that a deduction for mortgage interest on a taxpayer's principal residence must be maintained. Similar deviations from a pure flat tax, such as deductions for IRAs, certain taxes and charitable contributions, are probably inevitable.

The major flat-tax proposals currently strive to be revenue neutral. Even though fundamental tax reform on a revenue-neutral basis may be achieved for broad income groups, significant tax increases and decreases will inevitably result among taxpayers in such groups. The difference between marginal and effective rates presently found within industry groups, and even within the same industry, typifies this result.

A simple rate structure does not guarantee simplification. It is well known that many taxpayers find the use of tax tables too complex and frequently make errors in their application. Tax computations -- whether based on a single rate, only a few brackets, or the current multiple brackets -- will still be "complex" when used by taxpayers in a tax table format.

Base broadening. We support base broadening coupled with rate reduction as a tax policy goal. However, base broadening by redefining items of income and limiting deductions actually might increase complexity. This could occur because major changes will need to be accompanied by transition rules and because. More importantly, the reduced complexity of eliminating deductions may be counteracted by untested new rules (lacking authoritative interpretations) for measuring the additional inclusions in income. Many have decried (with good reason) the numerosity and complexity of tax law changes under the present system. Integrating fully a new tax system into the economy, however, certainly would necessitate years, even decades, of clarifying legislation, judicial and administrative interpretation, and public reeducation.

Thus the shock of adopting a flat tax would be substantial. Many personal financial decisions have been entered into with an expectation that the income tax system will remain substantially unchanged. These vested expectations involve decisions such as housing purchases and retirement. Consequently, a major change in federal income taxation could produce unanticipated tax consequences and erode confidence in the tax system individuals have relied on for long-term planning.

Since a flat tax envisions the abolishment of most income exclusions, certain valuation complexities will manifest themselves. For instance, many employee fringe benefits (e.g., employer sponsored day care for the children of employees) are not easily and equitably measured. And even if the measurement problems are resolved in the aggregate, complex allocations must be made to determine each employee's "income" share. The administrative costs of such computations and employee reporting would fall on employers, however, who would thus find a flat-tax system more burdensome in this respect.

Furthermore, most tax benefits are not unintended. They usually have been conceived, for instance, to promote social or economic objectives. Careful consideration must be given, on an item-by-item basis, to decide whether the simplicity criterion should supersede the social benefit obtained by incorporating the provision into the tax system. For example, the includability of such items as employer-pro vided fringe benefits, Social Security and Medicare benefits, interest on state and local bonds, and unemployment benefits certainly is subject to sharp debate.

Eliminate deductions. Should there be a standard deduction, a real property tax deduction or a medical expense deduction? Perhaps medical expenses and casualty losses can be justified on ability-to-pay and fairness ("the taxpayer has suffered enough") grounds. Similar justification for the home mortgage interest deduction and the state and local real property tax deduction is more tenuous. Charitable contributions and education expenses may be allowed as deductions on social grounds. The addition of Social Security benefits to the tax base may be construed as unfair by our senior citizens, who argue that they have contributed after-tax dollars to the system.

In this vein we understand that The Fair Tax Act (the Bradley-Gephardt proposal) would retain certain adjustments for mortgage interest, charitable contributions, state income and property taxes, payments to Keogh plans and IRAs, and medical expenses in excess of 10 percent of AGI. These Fair Tax Act deductions, however, may only offset income taxed at the 14 percent level. Irrespective of the taxpayer's marginal tax bracket (there are three tax brackets in the Bradley-Gephardt proposal), the tax benefit will be the same, i.e., 14 cents for each dollar deducted. Thus, ostensible deductions are in reality 14 percent tax credits, and the means by which this is effected in computing such a flat tax may create an even more complex tax calculation method than exists presently.

Congress should consider carefully whether a 14 percent "credit" for all the items enumerated above is proper tax policy, apart from its simplicity. For example, consideration should be given to whether such a proposed charitable deduction (credit) would produce the desired level of support for these institutions. The current system of credits and deductions has statutory and effective rates of tax savings that vary widely. To the extent policy goals are not achieved by a simple 14 percent "credit," proper adjustments would have to be made. However, the price to be paid for these adjustments in tax computation would be increased complexity.

Finally, while a revised tax system could eliminate the use of deductions and credits as indirect subsidies, it must be noted that many state and local income tax, property tax, and sales tax structures have become dependent upon the federal structure. On the one hand, a flat tax eliminating these deductions could have profound implications for many state governments because all states would not be equally affected by such a change. On the other hand, a flat tax that would retain features such as deductions or credits would not necessarily be simple. As tax professionals, therefore, we recognize that a flat tax guarantees neither equity nor simplification.

Would a Consumed-Income Tax Be Any Better?

Another of the many tax reform proposals that have been suggested is the consumed-income tax. Under this method a taxpayer is taxed on all receipts, less net savings. Loan proceeds are included in the tax base, whereas loan repayments (principal and interest) are deducted from the base. Savings typically would include investments in stocks, bonds and other securities, bank accounts, real estate, oil rigs and so on. The proceeds received from sale of a security or withdrawal from a savings account would be included in the tax base; of course, subsequent reinvestment would be deductible. The resulting tax base would be taxed pursuant to a progressive rate structure. Recently, the Brookings Institution has proposed its version of a consumed-income tax.*

The major theoretical argument in favor of a consumed-income tax is that it removes the present bias against savings and thus would favor an increase in capital formation. Whether this argument is in fact valid is unclear due to the tension between the income and substitution effects. Acceptable resolution of the issue must first be attained through modeling, statistical analysis and other forms of empirical testing. We therefore recommend that such critical testing be performed, to the greatest extent possible, as part of the analytical tax reform debate.

Of course, good tax policy must encompass much more than just the notion of high capital formation. In the preceding discussion of the flat-tax concept we examined some of the attributes that a tax system should possess. Our experience as tax professionals cautions us to be wary of the consumed-income tax initiative until the issues of design, complexity, measurement, fairness, administration, compliance, and transition are adequately resolved.

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*Economic Choices 1984, ed. by Alice Rivlin (Washington, D.C.: The Brookings Institution, 1984), Chapter 5.

Base broadening. The issues and problems inherent in the base broadening aspects of the consumed-income tax are similar to those inherent in broadening the present income tax base for a flat-tax base. Our flat-tax discussion already has covered this aspect of the tax reform debate and, for the following discussion of the adjustment for net savings, should suffice here as well.

Savings vs. consumption. A fundamental problem in designing a consumed-income tax is that of differentiating between savings and consumption. For example, does "savings" include investments in unproductive assets? How does one define "unproductive"? Should "investments" in collectibles, art works and antiques be categorized as savings? Each "investment" contains savings and consumption components such that distinguishing between the two becomes an exercise in subjectivity. If it is determined that these items constitute savings (and are therefore deductible), it still may be necessary to impute income as, and to the extent that, the items are enjoyed. As CPAs we can assure this Committee of the difficulty of measuring such an abstract quantity as imputed income. In addition, as explained below, imputing income may be perceived as unfair and violative of the ability-to-pay concept.

Owner-occupied housing. The treatment of owner-occupied housing is of great importance in the design of a consumed-income tax. Conceptually, the original investment in one's home can be construed as savings and thus be deductible. Subsequently, the owner-occupant would have to recognize imputed income for the use of his or her own home. Although homeowners may be delighted with the front-end deduction, they may be hard pressed to find the cash to pay the consumed-income tax on the subsequent imputed income. Surely these taxpayers (and their tax advisors) will find the imputed income measurement problem overly complex (if not insoluable) and the tax thereon unfair.

An alternative to the front-end deduction/imputed income design is to treat the original investment in the house as consumption (thus disallowing a deduction for the expenditure) and thereby obviating the need to impute rental income later. This method may be justified under the theory that the original investment is a proper measure of future taxpayer consumption. However, in the real world in which tax rates, interest rates and property values may change markedly over the life of a house, we have serious reservations about the purchase price being a proper measure of consumption value to the homeowner.

With respect to financing the home purchase under either of the above methods, additional fairness problems arise if the mortgage loan is included in the homeowner's income at the front-end (with corresponding deductions of subsequent loan payments). This would have a deleterious effect on homebuyers who would have to raise additional cash in order to pay the incremental consumed-income tax. An averaging device may be developed to spread the tax, but only with an attendant increase in the complexity of the tax.

Corporate tax. Another design problem that must be addressed is the place that a corporate tax has in the consumed-income tax model. On the one hand, some argue that a corporation does not consume and thus should be omitted from any consumed-income tax structure. On the other hand, others argue that through an integration process corporate income should be imputed to shareholders.

Outright repeal of the corporate tax would make obsolete the corporate tax return and remove the need for corporate tax audits. Compliance problems may be increased, however, since employees and stockholders of the corporation might be more prone to disguise consumption as business expenditures within the corporate veil, with attendant disrespect for the tax system. Furthermore, if the corporate tax is repealed, a withholding mechanism may have to be established in order to ensure that corporate earnings distributed to foreign shareholders do not escape tax altogether.

Finally, the issue of the lost tax revenue resulting from the repeal of the corporate tax must be addressed. If the present corporate tax is really passed on to consumers, an unacceptable shift in tax burden may result upon its repeal. For example, the "implicit" tax on a luxury automobile, which under the present system may be borne by the high-bracket purchaser, would (assuming pass-through) no longer burden the purchaser upon repeal of the corporate tax. This burden probably would be passed to less well-to-do taxpayers, with attendant perception of fairness problems.

Transfer taxes. There are significant issues to be resolved in the possible integration of wealth transfer taxes into the consumed-income tax structure. One possibility is to repeal the federal estate and gift taxes, with gifts and bequests included in the tax base of either the donor or donee. An alternative would be to include the transfer taxes within the consumed-income tax structure. Finally, perhaps the transfer taxes should be repealed with no correlative consumed-income tax on the transfer under the theory that any tax on wealth transfers is anathema to the capital accumulation motivation for a consumed-income tax.

Other fairness problems. In that under a consumed-income tax savings are excluded from the tax base, we are concerned that the resulting tax on labor will be perceived as unfair by the vast majority of wage earners. Further, this would not be improved by perceptions of the "rich" receiving large tax deductions for their savings, while the poor generally consume their income, thus having nothing to save and deduct.

As the economy enters a recession, the people hit the hardest, such as the unemployed, will have to dip into their savings for consumption, with an attendant increase in their tax liability. These individuals will then have to deplete their savings even further to pay the tax.

The consumed-income tax also is inequitable because it impacts on the young and the old the hardest -- those who consume a greater percentage of their income than do the middle-aged. A couple that is able to save for their child's college education in their younger, low-bracket years will receive savings deductions in their younger years worth less than the correlative dissavings income in the couple's high-bracket years when they pay for their child's education.

Other administrative and compliance problems. A leading economist has labeled the consumed-income tax a practical monstrosity.* Administration and compliance would be part of the problem. For example, taxpayers would have to maintain detailed financial schedules in order to keep track of their various consumption/savings transactions.

Banks and other lending institutions may be required to determine whether the proceeds of a loan they extend to a borrower are to be used for business/investment purposes by the borrower or for consumption. In the latter situation, the lender may be required to withhold (the loan proceeds being included in the borrower's income), whereas in the former the lender may not (the borrower receives an offsetting savings deduction). The borrower may have to attest to his anticipated use of the funds in his loan application. Perhaps the lender will have to verify the borrower's intent. Thus, administrative and compliance problems have multiplied and costs have increased.

Even the United States' relations with other countries may be affected by our adoption of a consumed-income tax. Steps would have to be taken to assure that individuals are not unfairly advantaged or disadvantaged by the fact that there is a consumed-income tax in the United States and, for example, an income tax in another country. For instance, income earned and taxed in another country should not be subject to further tax when it is consumed in the United States. On the other hand, U.S. residents should not be able to avoid tax by saving for retirement here and then moving to a relatively tax-free country to enjoy (i.e., consume) their U.S. savings.

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*Joseph Pechman, "Taming the Deficits," Tax Notes (April 16, 1984), p. 317.

Transition problems. Perhaps the thorniest problems to be resolved with respect to a consumed-income tax are those of transition--how to get there from here. To the extent that savings have been taxed under the present income tax system, they should not be taxed again under a consumed-income tax. However, this should not apply, for example, to IRAs and certain pension funds received during consumed-income tax years.

Thus, extremely complicated tracing and transition rules would be necessary in order to effect a change to a consumed-income tax. Detailed recordkeeping both before and after the changeover would be required in order for a taxpayer to sustain his burden of proving the propriety of consumed-income tax adjustments for prior income taxes on savings.

Finally, problems of reeducating the public about the consumed-income tax would be enormous. For the new system to work, the public must perceive it as both fair and relatively simple, which for the reasons we have presented will be no small task.

REFORM OF THE PRESENT TAX SYSTEM:

SOME PROBLEMS IDENTIFIED AND SOLUTIONS PROPOSED

We believe that there are certain systemic problems with the present income tax system. Obviously, these should also be addressed in your consideration of any alternative system. We therefore think that study of the problems and proposed solutions noted below would improve any tax system, especially the current one.

Educate the Public About the Tax System

Public misperceptions. Any truths about the tax system are irrelevant if the public perceives something entirely different to be true. For instance, if taxpayers believe that the tax system is unfair and that everyone else understates taxes, these perceptions, although erroneous, may nonetheless serve to rationalize impropriety. Therefore, as such misperceptions continue to be emphasized, they can distort reality and mislead taxpayers. Consequently, an important element in assuring compliance and satisfaction with any tax is how it is perceived by taxpayers.

Similar misperceptions apply to the sharing of the tax burden among various income categories of taxpayers. A revealing survey in 1977 by the Roper Organization found that 64 percent of the over 2,000 respondents labeled the U.S. income tax "unfair." Interestingly, Roper concluded that most Americans have a "gross misunderstanding of and lack of information about how the income tax system works."* Among the survey findings were several incorrect perceptions about the U.S. income tax as it existed in 1977:

- The average respondent estimated the income tax paid by families earning $100,000 was 13 percent of income instead of the actual average of 35 percent.
- The public thought at least half of the families earning $500,000 or more paid no tax, when only about 1 percent of such taxpayers did not pay any tax.
- A majority of the respondents generally believed high-income people and corporations are undertaxed while middle- and low-income groups are overtaxed.

Combating such misperceptions is a difficult task, but nevertheless it should be attempted.

Understanding the tax system. A related problem that produces similar dissatisfaction is the general lack of public understanding as to how the tax system works. On the simplest level, there is a considerable lack of understanding of what is included in income and permitted as deductions. For example, two small businessmen -- a dentist and a hardware store owner -- trade dental services for a new lawnmower. The fact that neither reports the income from this transaction could be due to the previously noted reasons of thinking that the system is unfair, and nonreporting unlikely to be detected. But in addition to these rationalizations, certainly many taxpayers have no idea that the exchange is a taxable event.

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* As quoted in "Public Seen Resisting Tax Plan if Carter Reduces, Omits Widely Used Deductions," The Wall Street Journal, 27 July 1977, p. 3.

To help overcome this state of erroneous perceptions and lack of understanding by most taxpayers, we propose that Congress and the Administration make a commitment to a broad-based program for educating the public about the tax system. Such a program could use different media -- including television, radio and newspapers -- to teach the public the facts (i.e., correct their misperceptions) about the tax system. Further, these same methods could provide knowledge about significant national or regional reporting aspects of the system -- using as a criterion for topic inclusion in any program only that it inform a substantial portion of the taxpaying public. While we realize that the Internal Revenue Service has in recent years instituted major public relations programs to educate taxpayers about the workings of the tax system, we believe that the content of such programs should be appropriately modified and their scope significantly expanded.

Finally, we would like to observe that some of the public fascination with the various flat-tax proposals is undoubtedly due to the fact that most taxpayers do not understand the differences among marginal, average and effective tax rates. If they did, they would know that a revenue-neutral proposal that aims to avoid shifts in the tax burden could not possibly change individual tax liabilities substantially. Instead, higher flat-tax taxable income (resulting from base-broadening rules) would of course permit lower marginal and average rates in the course of keeping the tax about the same. In addition, all of the rates, including the effective rate, would be clustered much more closely together. The differences between marginal, average and effective tax rates and their methods of computation also should be a likely topic for inclusion in a taxpayer education program.

Direct Communications Concerning Tax Provisions of Interest to Typical Taxpayers

Communications about the tax system should focus on increasing taxpayer awareness of how it functions. For example, public service announcements on television should focus on expanding taxpayer awareness of the tax benefits and reporting requirements that are applicable to individual taxpayers and the circumstances or conditions necessary to obtain these benefits. In addition, television spots should extend beyond the current 30-second public service announcements shown between January 1 and April 15. Longer informative presentations should be made when possible. Furthermore, those presentations should appear when of greatest concern to taxpayers. For example, information on the residential energy credit should be presented when research indicates individuals are typically purchasing insulation and undertaking other qualified energy conservation measures.

Increased funding also should be made available for communications to inform taxpayers of the ease with which they might prepare their own returns. Commercial tax preparation services have portrayed preparation of even the simplest return as beyond the ability of the average taxpayer. Advertisements to the effect that "We Prepare Form 1040EZ" appeared frequently this year. Undoubtedly, some taxpayers need assistance with Form 1040EZ; however, many taxpayers may not be aware of the minimal work necessary to prepare Form 1040EZ or Form 1040A once the information needed to complete the return is gathered. Information gathering generally must be performed by the taxpayer anyway.

Press Releases to Improve Confidence in the System

Government press releases to the media should be focusing more on how well the tax system works, than on emphasizing its breakdowns. Careful consideration should be given to the effects that government press releases have on taxpayer perception of the tax system. Press releases should avoid any suggestion that tax evasion is broader than the facts support. In addition, studies should be commissioned on the cumulative effect that government press releases have on perception of the income tax. It is possible that this cumulative effect may be a general impression that tax abuses are widespread. Creating such an impression may serve to erode public support and confidence in the self-assessment system.

A related area that should be given additional study is the effect that the use of tax evasion prosecutions to secure convictions of individuals primarily for other breaches of public trust has had on public confidence in the income tax. When communicating the government's actions to the public -- through press releases, press conferences, etc. -- care should be taken to put a proper perspective on the nontax offenses. By prosecuting individuals solely or principally for tax crimes, the government inadvertently may be creating an impression that tax evasion is much more widespread than it is. In other words, government press releases may be creating the impression that these are prosecutions of otherwise law-abiding citizens (or public figures) who have evaded tax laws, rather than prosecutions of persons who by concealing other crimes have violated the income tax laws.

Increased Appropriations to Improve Taxpayer Compliance

In our self-assessment system, many taxpayers turn to tax professionals for assistance in fulfilling their legal obligations. Many taxpayers look to governmental employees for this assistance. Others turn to tax professionals in the private sector.

As a major international accounting firm, Ernst & Whinney is deeply concerned with improving the relationship between tax professionals in the public and private sectors. The focus of this section of our testimony, however, is not on the improvement of these relationships. Instead, the suggestions we present today primarily will benefit taxpayers who look directly to the federal government for assistance in meeting their self-assessment responsibilities. Specifically, we believe that improvements in taxpayer assistance, the examination function, and appellate procedure would be of great benefit to the average individual taxpayer. If implemented, these changes would improve both the fairness of the existing system and taxpayer perception of that fairness.

Institute a separate taxpayer assistance division. In order to improve both the fairness of the existing income tax system and the perception of its fairness, increased appropriations should be made to enhance taxpayer assistance programs. These programs are frequently the only voluntary contact individual taxpayers have with the IRS. At least two benefits might be derived from an increased commitment of resources to taxpayer assistance: (1) compliance could be improved if taxpayers had additional resources to turn to for assistance in resolving basic questions of tax law; and (2) the increased availability of IRS services could personalize the tax process and improve confidence in a taxpayer's ability to prepare his or her own return. By way of example, consideration might be given to the expansion of the use of toll-free numbers for specific requests such as the proper form(s) to be used to report a transaction or the solution to common individual tax problems (e.g., the sale of a personal residence).

A comprehensive commitment to improving taxpayer assistance should not be made without conducting research on what services are desired by taxpayers. Part of the decline in taxpayer confidence in the federal income tax system may be due to the cutbacks in appropriations for taxpayer assistance programs. We believe that this confidence could be restored by reversing the pattern of budget cuts and, if possible, by exceeding historical commitments to taxpayer assistance to provide the services desired by taxpayers.

Increased commitment to the examination process. As with many of our proposals, a commitment to improving the examination process should both simplify the existing system and improve taxpayer perceptions. We commend the Service for improvement of the audit process despite decreased appropriations. The process of improving the selection of tax returns for audit has not necessarily meant a decline in the quality of the audits performed. To the contrary, the emphasis on identifying those returns with the greatest likelihood of adjustments should be continued.

Nevertheless, attention should be given to the proper level of audit frequency. If the level of audit frequency that cost-benefit analysis indicates will produce optimal levels of taxpayer compliance can be identified, then appropriations should be made to attain that level. In making this analysis, consideration should be given to both the costs to taxpayers of complying with examinations and the costs to the government.

Furthermore, it is important that the Service's success in better targeting returns to be audited be communicated to the public. The decline in the total number of audits has been much more highly publicized than the improvements in selecting returns for audit. The failure to convey the effect of both of these changes in the selection process has meant that taxpayers now perceive that the probability of a questionable item being audited is lower than in the past. A perception that the probability of an audit has shifted in favor of the taxpayer has eroded public confidence in the tax system because it is seen as an invitation to play the "audit lottery," a phrase coined by the government and disseminated to the public as a widespread pursuit of many taxpayers.

Reestablish a District Conference. Prior to 1978, the IRS had a two-stage appellate process. In 1978, the District Conference was abolished, and all appeals now proceed directly to the Appellate Division. We believe that the District Conference should be reestablished. A District Conference would help improve taxpayer confidence in the fairness of the tax system by providing an earlier, less formal setting for reviewing disputes. Also, an opportunity for a fresh look at disputes at the District level might result in a more efficient use of the Service's appellate-level dispute-resolution mechanisms. Consistent with the ends sought to be achieved in reestablishing the District Conference, such a conference might be limited to "small" disputes in a manner analogous to the "small case" in Tax Court. Furthermore, if necessary to avoid an undue burden on the Service, certain issues such as those involving tax shelters and/or tax protests might be precluded from consideration at the District Conference level.

Legislative Enactment and Review Process

Impact statement. Consideration of proposed tax legislation should require a full analysis of its impact on, for example, the economy, forms preparation and taxpayer behavior. It seems as though tax legislation is too frequently enacted with numerous technical errors, unintended loopholes and severe consequences for certain sectors of the economy. Moreover, a year-end enactment often leads to delays in availability of forms and authoritative explanations for timely filed returns, and the proliferation of forms that are often difficult to complete has frustrated many taxpayers. This suggests that if environmental impact statements are required to assess proposed changes to the environment, then shouldn't a similar assessment be made of the impact of proposed tax law changes on the tax environment, i.e., the tax system and the effected taxpayers? In our view, the potential impact of a significant proposed change in the tax law should be analyzed critically before enactment in order to reduce the number and severity of unintended side effects that subsequently must be dealt with. The extensions of the original issue discount rules by the Deficit Reduction Act of 1984 is a prime example of the kind of complex legislation that could have benefited from this type of analysis.

Feedback of revenue effects. In a tax legislative system that currently is primarily estimated-revenue driven, it is curious that there are no mechanisms in the federal budgetary and reporting process to evaluate on an ex-post basis the actual revenue gain or loss from tax legislative changes. While this has been done on an ad hoc basis for a few very significant tax changes, e.g., the 1978 increase in the long-term capital gain deduction, there is no formal requirement or method for evaluation. This is hard to imagine, since sound management procedures specify that when changes are made with a budgetary effect, they should be evaluated subsequently by comparing the budgeted amounts with the actual results. Although the estimates of revenue effects accompanying a congressional committee report are not technically budgetary items, the principle of subsequent review to assess the fiscal consequences should still be followed. Admittedly, there are some factors that limit the current use of this feedback approach. For instance, a change may not be a line item in a later report, or there may be no way to measure in the aggregate the consequence of affecting one of many stochastic variables. Nonetheless, there are ways to take actual data and attempt to isolate the effects of a change, notwithstanding that numerous other economic variables have changed as well.

The presence of such a "feedback loop" would both enhance the state of the art of estimating revenue effects and provide necessary information for Congress and the Administration to evaluate the appropriateness of prior decisions concerning tax changes. Since the tax expenditure budget is prepared each year and experience has been gained over the years in generating it, such a feedback loop should be feasible. The current lack of feedback in the government is like a business which buys a machine and then never receives any operating cost or productivity data. Simply stated, this is not the optimal way to account for revenues and expenditures of an operating organization, be it a business or a government.

Proposal for a National Commission

A national commission should be created to review and suggest reform proposals for the present federal income tax system. In order properly to evaluate alternatives, this commission would need the support of both Congress and the Administration. It should consist of representatives of Congress, the Administration, tax professionals and taxpayers so that a broad view is encompassed.

This commission should be assigned the task of submitting its reform proposal, including appropriate transition rules, within three years of its formation with a view to implementation in five years. In addition, Congress and the Administration should agree not to make any substantial structural changes in the income tax laws until the commission's reform proposals have been submitted and their implementation considered.

There are many reasons for establishing the commission and imposing a moratorium on substantial structural tax law changes. First, there has been an accelerating tendency to enact legislation without full consideration of its economic effects or its administration. For example, legislation involving carryover basis at death, the generation-skipping transfer tax, and the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) have each created complex problems of administration. These problems resulted in outright repeal of carryover basis and filing date postponements under the generation-skipping transfer tax and FIRPTA.

Further, in the last 15 years there have been approximately 20 major tax acts. Since the Tax Reform Act of 1976 nearly eight years ago, there have been at least 10 of these tax acts. While several of these acts were carefully crafted after intensive study of the area to be legislated -- as for example the Bankruptcy Tax Act of 1980, the Installment Sales Revision Act of 1980, and the Subchapter S Revision Act of 1982 — many others contained provisions whose effect was not as carefully studied before enactment. In contrast, a national commission would be able to carefully consider proposals without being burdened by other legislative pressures. A moratorium on tax legislation affecting significant structural changes in the income tax would give the commission this opportunity.

Second, the increasing pace of tax legislation has had an enormously disruptive effect on the country's business and political environment. In our experience as accountants, we have noticed that business planning that involves the commitment of substantial human and capital resources over time is hampered by constant tax law changes. For example, planning for the construction or acquisition of depreciable property is affected severely by a constantly changing pattern of cost recovery, investment credit and leasing rules. Similarly, we have observed that research activities involving significant time between project commencement and completion may not be given the opportunity to bear fruit if the tax treatment of amounts spent for such activities undergoes constant change. Whole industries, for example insurance and housing construction, must survive in the uncertainty of the tax treatment of their ordinary day-to-day transactions. In short, there must be some stable tax framework in which business may plan its transactions in order to promote a long-run efficient allocation of resources. A constantly changing tax law can create a constant stream of unrecovered transaction costs for cancelled plans.

Moreover, the increasing pace of tax legislation has also disrupted our political environment. Congress has been spending a considerable amount of time on tax bills to the detriment of other legislative matters. The rising volume of tax legislation has increased the activity of special interest groups and lobbyists pursuing their own requests for dispensations. These phenomena further erode public confidence in the fairness of our income tax and create unwarranted complexity in the Code.

Third, the massive scope and sheer volume of recent tax law changes defies the comprehension of many tax professionals and even more so for nontax professionals involved in corporate operations. We have noticed recently that many sophisticated nontax professionals have become bewildered by the increasing velocity of tax law changes.

Fourth, the increasing pace of tax legislation has made it extremely difficult to interpret current tax law. Until regulations are published, little authoritative guidance is available. The rapid change of tax laws also reduces the reliability of authoritative interpretations, whether in the same or a related area.

Fifth, the constant flow of tax legislation has made it difficult for Treasury to issue regulations on many Code sections for which guidance is sorely needed. Nearly 400 regulation projects are currently outstanding, some going as far back as 1969. We understand that between 125 and 200 more regulation projects will be necessary just to interpret the 1984 act. Planning and compliance are difficult when many details of a new law are not interpreted for a considerable length of time after enactment. For example, many questions under Section 338 are still unanswered, even though this section affects multimillion dollar corporate acquisitions and has been in effect for nearly two years.

The reasons for a moratorium on substantial structural tax changes were noted at least seven years ago. Immediately after the Tax Reform Act of 1976, Professor James Eustice suggested that the pace of legislation be slowed down a bit, stretching out both its frequency and speed of enactment.* The AICPA's Federal Tax Division has for some years expressed similar concern about the "accelerating pace of tax law changes." In 1978 testimony before the House Ways and Means Committee, it warned Congress that constant changes "make it very difficult to plan ahead and may very well be impeding business expansions and development."** Without a moratorium while the commission deliberates, we will be making the problems worse while the commission is trying to plan their solutions.

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* J. S. Eustice, "Tax Complexity and the Tax Practitioner," The Tax Adviser (January 1977), p. 35.

**Reported in "Taxation: AICPA Tax Division Warns Code Changes Hurt Economy," The Journal of Accountancy (June 1978), p. 24.

Items to be Considered by the Commission

The Deemed Capital Transaction approach. The broad issue of full integration of the corporate-shareholder system of taxation, which was discussed in the late 1970s, has declined in relevance in view of ACRS having decreased the burden on corporate savings and investments. However, care must be taken to assure that any fundamental restructuring of the tax system does not swing the pendulum back in the direction of overtaxing capital. Accordingly, a partial integration approach is still pertinent and viable if it enhances simplicity and reduces the negative effects of our tax system on capital formation. An example of this method of simplification, which should be considered by the commission, is the Deemed Capital Transaction approach to partial integration of corporate-shareholder taxation.

The Deemed Capital Transaction approach, which was previously set forth by Ernst & Whinney before this Committee on October 24, 1983, would result in the repeal or simplification of much of Subchapter C, as well as of the accumulated earnings tax and the personal holding company tax. The proposal envisions that all distributions from domestic C corporations be treated as "Deemed Capital Transactions." The amounts distributed would be subject to long-term capital gain and alternative minimum tax treatment, with the elimination of earnings and profits as a measuring concept. However, capital losses would not offset such distributions, and corporate recipients would still qualify for the dividends-received deduction.

full consideration for several reasons. Its adoption would provide a significant reduction and elimination of certain issues that have given rise to a disproportionate amount of tax litigation. For instance, corporations would no longer be used to accumulate earnings, since the tax cost of distributing earnings currently or in an eventual redemption or liquidation would be equalized. Dividend equivalence and thin capitalization would cease to be major tax questions. The bias in favor of debt financing over equity investment also would be reduced, thereby reducing both the demand for credit and interest rates. While the maximum combined corporate-creditor federal tax rate for debt-financed earnings would remain at 50 percent, the maximum combined corporate-shareholder tax rate on earnings generating distributions would be reduced from 73 percent to 56.8 percent. Hence, debt/equity issues would be minimized and Section 385 could be repealed.

Since the distinction between redemptions and dividends would be eliminated, the current tax bias in favor of corporate retention of earnings would be eased. Ultimately, more equity investors rather than corporations would decide where to reinvest earnings. This would tend to stimulate capital mobility and utilization and reduce the centralization of capital.

Commission task forces. We also recommend that the Commission establish specific task forces to review and offer targeted proposals in certain areas. The following are representative examples of suggested task force subjects:

- Revisions in Information Reporting: [illegible] ing problems arise, for instance, for fiscal year taxpayers who receive calendar year information returns.

- Uniformity of Rules in Areas of Common Application: The requirements for the timing and calculation of contributions with respect to Individual Retirement Accounts, Keogh plans, SEPs and other pension plans should be examined to determine whether they could be made more consistent.

- Compliance-Oriented Measures Directed at the Cash Economy:

  - Whether deductions should be allowed for cash payments for which no audit trails exist in the form of receipts or checks.

  - Whether a deduction ceiling for aggregate undocumented cash-paid deductions (e.g., charitable contributions) might be appropriate.

  - Whether disallowing deductions for payments to independent contractors unless there was information reporting of such payments would encourage compliance.

- Monitoring Compliance with Disallowance Provisions: It should be determined what information is necessary to enforce provisions such as Section 265, Expenses and Interest Relating to

Tax-Exempt Income. Also, information reporting of tax-exempt interest should be evaluated for its administrative feasibility.

- Objective Rather Than Subjective Standards for Code Provisions: Taxpayer certainty might be increased by replacing subjective standards with objective standards in the Code. This would result in a reduction of litigation over contentious issues. For example, in the estate tax area the contemplation-of-death standard was changed to a within-three-years-of-death test in furtherance of this purpose. Numerous other items and areas potentially are capable of such resolution, with a resultant simplicity in the law.

STATEMENT OF NORRIS FARNELL III, CPA, SKAGGS & FARNELL, TEXARKANA, TX

Senator DANFORTH. Mr. Farnell.

Mr. FARNELL. Senators, my name is Norris Farnell; from Texarkana, TX. And I certainly appreciate the opportunity to be here and to present my views.

I feel along the same lines. There is a general misconception in the Internal Revenue Code. There is a perception that we have progressive income tax rates. The rates, of course, lower for the poor; higher for the rich.

I consider this a fiction, a fallacy. I practice public accounting. My average client is $30,000 a year plus. The people making between $30,000 and $40,000 a year, there is absolutely nothing we can do to reduce their income tax burden. Once that income climbs to $50,000, $60,000 a year, depending upon the aggressiveness of the individual, you can reduce that tax rate to zero.

I had one individual who made $100,000 a year. Ended up falling under the earned income credit tables and received a $500 refund from the Treasury. He had only $5,000 in taxable income. Everything was perfectly legal; everything perfectly proper.

The reforms every year—we have new tax laws. Every year they become more complex. They become more confusing. As you try to legislate for individual situations, individual business transactions, we have an unending spiral of point and counterpoint. You try to close a perceived loophole. There are legions of CPA's and tax attorneys that find ways around these, find new ways, new methods, new techniques.

It is my belief that the only fair and equitable tax on a national level is some type of consumption tax. Consumption tax has been said to be regressive. It penalizes the poor. In actuality, a consumption tax taxes spending, not savings. Under our present tax laws, you encourage people to go out to borrow money, to buy duplexes, to buy office buildings.

Right now, Houston has a 25-percent occupancy rate in its office buildings that the Treasury is financing. A consumption tax will encourage savings. The people in the lower brackets who currently are not now paying any taxes, you could simply increase the Federal transfer payments by 14 percent, which is what it would take to equal the revenues the Treasury collected. Increase these transfer payments by 14 percent. You are going to collect it back in sales tax in the future anyway.

I feel there is no way to reform the current tax laws. As long as you are charging people 50 percent of their income, they are going to find ways, they are going to work, they are going to spend the money. It's just as important to spend as much time and effort learning how and trying to keep your moneys as it is to earn them in the first place.

Thank you very much, Senator.

Senator DANFORTH. Thank you.

[The prepared written statement of Mr. Farnell follows:]

PREPARED STATEMENT OF NORRIS FARNELL III, CPA

Mr. Chairman, Honorable Senators:

As a Certified Public Accountant and Practicing Accountant for over thirteen years, I have had numerous opportunities to observe the inherent abuse in our current income tax system. The perception of the general taxpayer that I see ($30,000 per year and over) is that the current income tax system is too onerous to bear and that taxes are to be avoided at any cost. I see physicians making $200,000 a year spending $100,000 to $150,000 in tax shelters so that they will not have to pay any income tax. In thirteen years, I have never seen a tax shelter realize any profit for anyone except the promoter, but still, people had rather gamble on some long term scheme than to pay the Treasury income taxes. The American taxpayer would save his money if Congress would let him rather than throw it away on so called 'tax shelters'. Look how rapidly IRA's have grown! Wouldn't it be better for our economy to have these wasted funds deposited into savings accounts and available for loans to finance true economically sound ventures?

I have spent my career helping people avoid taxes that really have no objection to paying their fair share of the cost of a free society. Nearly every year Congress passes a new tax law trying to plug one "loop-hole" or another and every year legions of tax attorneys and accountants find novel ways to find new ones. The tax law has become so complex with this plug and unplug syndrome that the Internal Revenue Code of 1954 has become a work of fiction. There is no way the government can match the manpower or monetary resources of the private sector when it comes to saving a tax dollar.

There has been much talk of a new flat rate or adjusting the current tax rates. As seen in Exhibit #1 any change in rates whether up or down really only affect those people earning between $20,000 and $80,000. Tax rates have very little real effect with itemized deductions, only slightly more. The real problem is not whether to increase the tax rate or allow interest deductions; but rather how you define income. Every time Congress tries to change the definition, we are able to redefine it again.

As Exhibit #1 illustrates, there is not much a taxpayer can do to reduce his taxes until he reaches about the $50,000 income level. At this point, an effective tax advisor can begin reducing a taxpayer's tax rate until it becomes zero. I have one client who earned over $100,000 in 1983, yet by utilizing only the standard deduction, had taxable income of only $5,000. Not only did this taxpayer have a zero effective tax rate, he qualified for the earned income credit and received a $500 refund from the Treasury. This is not an uncommon case and is perfectly legal and proper. Take the case of the individual who bought a duplex for $150,000, collected rents equal to his mortage payment and sold the duplex for exactly what he paid for it. In this situation, there is absolutely no economic gain to anyone, yet this 50% taxpayer saved $75,000 in taxes and only paid $30,000 when he sold the unit. He made $45,000 from this transaction merely by playing the game in this very unsophisticated and unimaginative tax shelter. Congress may try to stop these techniques, but as long as a taxpayer is paying half of his earnings in taxes, he will pay his accountant or attorney to create new techniques.

I am sure you have heard much testimony from many special interest groups as to why this deduction or that is fair or unfair or why rates should be higher of lower or flat. Regardless as to how the public perceives them, these items only effect the middle income taxpayers. Your real challenge is how you define income, and you cannot succeed, because I, and millions like me, will invent a new "income" that you have not thought of.

There is only one way to establish a fair and equitable tax system. A national sales or value added tax of 14% would result in the same revenues that the Treasury Department collected in 1982. Actually, with all the fiction contained in the nation's tax returns, I am not so sure that GNP isn't much higher than the reported 3 trillion dollars which would allow us to have a rate much lower than 14%.

Even though a value added tax would be more favorably received by the public, it is still a tax on GNP and much more difficult to administer than a sales tax. In a value added tax, we once again get into definitions. With a sales tax, we have minimal definitional problems and; the states already have a collection system in place and years of experience that could be called upon in drafting federal statues. The federal government could, in fact, pay the states some percentage for collecting the tax and eliminate the need for maintaining the massive IRS bureaucracy. What kind of burden would be lifted from our federal courts if all tax cases suddenly stopped? What would it do to our interest rates if monies started flowing into Certificate of Deposits instead of tax shelters? How responsive would fiscal policy be if all Congress had to do was raise or lower the tax rate? How many more business decisions would be based on economic reality rather than tax advantages?

Many economists will say that a sales tax is regressive and hurts the poor while our income tax is progressive and takes a larger share from the rich. I hope that I have shown, through the fiction of the Internal Code, our income tax is only progressive through the middle incomes and then becomes extremely regressive.

It is true, however, that a sales tax would be extracted from those taxpayers earning below $10,000 per year which they do not pay taxes on currently. It would be unfair to collect taxes from these people under the proposed system without some assistance. By and large, the very poor are already on some type of assistance and it would be very simple to issue them a check which the Treasury will simply collect later in sales tax. What about the elderly and those receiving social security and other federal transfer payments? Once again, simply increase these checks by 14% and collect back through sales tax.

It is a basic truism of our tax laws that you can accumulate wealth through assets but not through cash. Congress, by taxing income, encourages borrowing and spending (negative income). Why should the person who wishes to save be taxed and the person who spends be untaxed?

Under the national sales tax system, all would be taxed equally. The poor would not be hurt and the burden would be lifted from the backs of the middle income earner.

The man who saves his money would not be taxed. The man who entertains customers on a $40,000,000 yacht would pay almost $6,000,000 in taxes. Under this proposed system, it would have to be a mighty valuable customer to warrant this kind of expenditure.

Are we to have business decisions based on the economic reality of a national sales tax or are we going to perpetuate the fiction of the Internal Revenue Code?

Norris Farnell
Certified Public Accountant
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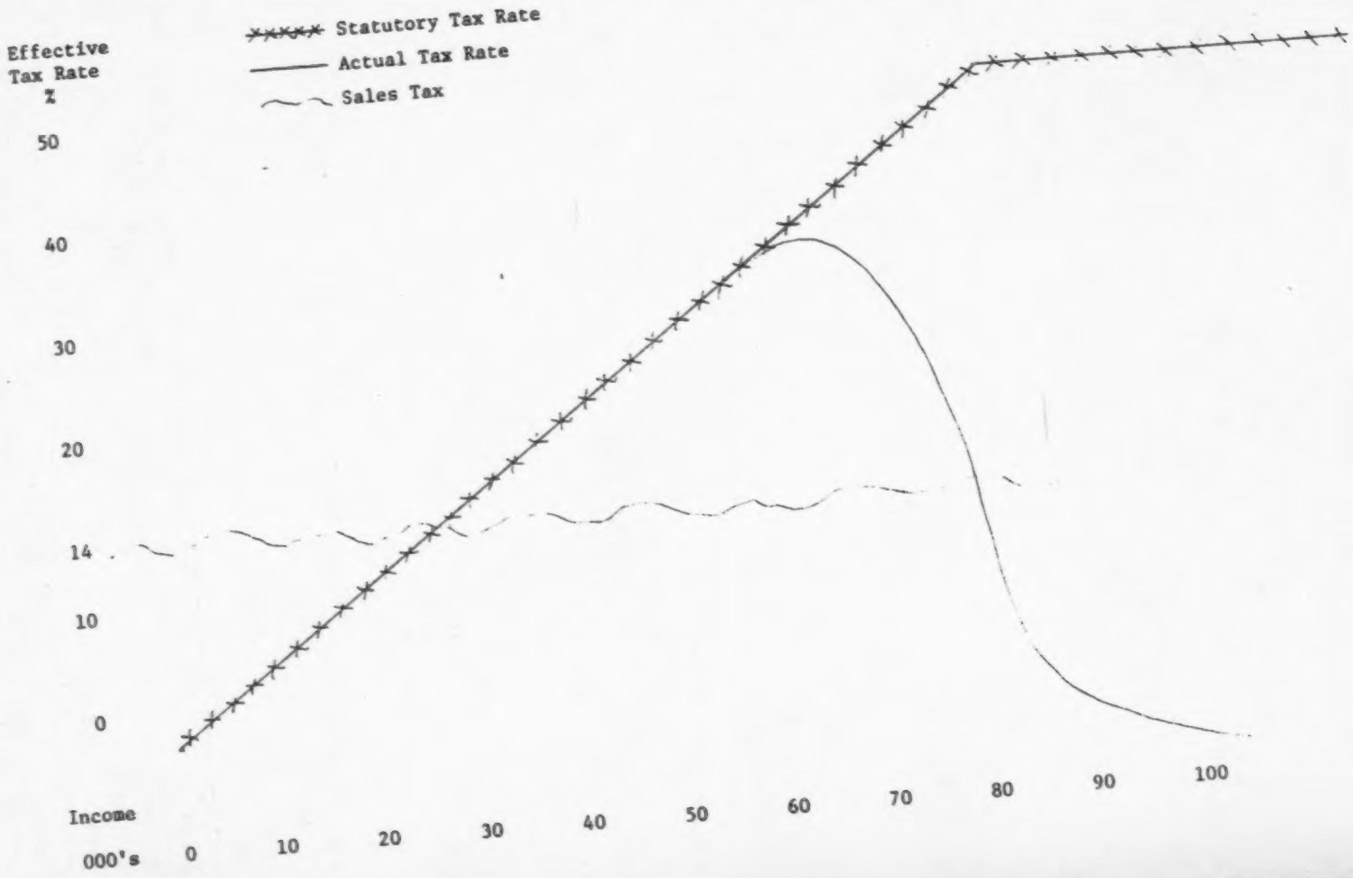
EXHIBIT #1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Senator **Danforth**. Gentlemen, you are both practitioners. I guess this is asking you really a rhetorical question. How important is it for people of high income to have a tax lawyer or a tax consultant who really knows his business?

Mr. **Farnell**. Sir, I would say it was absolutely imperative.

Mr. **Berenson**. Well, it becomes an ecomomic necessity. And I don't think it's the concept of higher taxation that mandates that. I think it's the fact that in our never ending quest for equity, and the use of the tax laws for social and economic purposes, as well as revenue, we have engaged upon staggering volumes of change after change, complexity after complexity in the search for equity; that makes the tax law a veritable mine field, pitfall and trap for the unwary. When you are in a high income bracket, it's an economic necessity that you do not unintentionally fall afoul of many of the penalty provisions that now permeate the code.

Senator **Danforth**. Do you think that tax practitioners find it relatively easy to stay on top of what is happening to the tax laws, or do you think that it is getting more and more difficult and more and more perilous to be in this practice?

Mr. **Berenson**. I think they have the same ease as the Members of Congress and this learned body has.

Senator **Danforth**. That does not give me great confidence.

Mr. **Farnell**. Senator, I would like to say that it's impossible. I would like to relay the situation that happened to me when I was out in west Texas in the seventies when they passed the reform act on oil and gas.

This law was passed in September; retroactive back to January 1. I called—I had an interpretation of a particular section. One interpretation, my client would have to pay $400,000 in taxes. Another interpretation of the law, my client would receive a $400,000 refund. Another interpretation, he would pay $20,000 in taxes.

I called the national office of the Internal Revenue Service. Talked to the chief of the oil and gas branch. His name was Mr. Reagan. I cannot go much higher than this.

Mr. Reagan said, "Norris, I can see where you got all three interpretations. All three are excellent."

I said, "Well, yes, sir, I understand. I'm not saying I'm going to follow it, but I would like to know what the Treasury's position would be."

He said, "Well, Norris, we are going to wait 3 or 4 years and see what you fellows in the field do and then we are going to make our decision."

Senator, it's impossible to operate under that situation.

Mr. **Berenson**. Senator, I would add a cautionary note of concern. You have been focusing on valid problems of complexity in our tax laws. As practitioners we are hampered by knowledge of some of the adverse impacts that continued change bring no matter how well-intentioned. You have to be careful about throwing the baby out with the bathwater because this is probably the most highly industrialized, complex society yet created. And for many years, probably right up through the late sixties, the tax system, with many of its faults, did function fairly well. Then when it ran into inflation and interest, it started to get very, very complex at the upper levels in the quest for fairness and equity.

However, you are still talking about elements of extreme complexity that in most cases do not affect the vast majority of individual taxpayers. But with all the media coverage, there has become that clear perception that it is impossibly complex for everyone and that some taxpayer is benefiting by such complexity. Whether that perception is reality, the public believes it to be so. And I don't think we should always just focus on those very, very intricate corporate reorganization problems and high-bracket individual complexities as being representative of the tax returns that are prepared for the vast body of American taxpayers.

Senator DANFORTH. Senator Long.

Senator LONG. Mr. Berenson, your testimony prompts this question. When Larry Woodworth was with us—I guess you knew Larry. He headed our Joint Tax Committee staff.

Mr. BERENSON. Yes.

Senator LONG. At one time I discussed with him the possibility of giving a taxpayer some additional options. For example, some taxpayers are required to itemize in order to get the benefit of claiming the interest expense on a home mortgage. It occurred to me that if we would simply provide an additional form tailored to the situation of one who has a high interest expense, that those people could itemize for only one item. They would get a lower zero bracket amount, because the zero bracket amount is a part of the advantage of filing a simplified form. They would have to give some of that up in order to get additional the benefit of a home mortgage interest deduction.

You could design a form that relates just to taxpayers in that situation. Let's call that a form 1040–M because it would fit people with a mortgage on a home.

Then a lot of people itemize because they have high State and local taxes to contend with. You could have a special form for them so that that group would find it to their advantage. Let's call that a form 1040–T. That would be for people who have a lot of taxes to pay to the State and local government.

Then you could have a third one where it would fit the largest number of situations, which might be in the area of casualty losses, or health expenses, or maybe a combination of the two. But one would only need to itemize in the particular area that makes it necessary for him to itemize.

Larry Woodworth contended that if you did that, you wouldn't have but about 5 or 10 percent at most of taxpayers who would be itemizing all the items that we itemize today. You would have the form as simplified as you could make it for those other categories. But by doing so, you would have very few people that itemize except in the one area that fits their circumstances.

There might be one more thing. Take the people who are your clients and give them an option. Say that they could pay at a lower rate if they don't claim an entertainment expense and they don't claim accelerated depreciation, they don't claim all the different things that you accountants are very good at showing us how to handle—we can't do without you—but just go ahead and pay taxes under the way it was before we started reforming.

This would be a very simplified way; they would pay taxes on a higher taxable income, but they would pay taxes at a lesser rate.

You could offer a businessman that kind of an option. If you did that, you would have made the code more complex.

But as far as this fellow with a mortgage is concerned, he only has to find out one time that he wants the a form 1040–M. That's his form, and it's very simple for him from that time on. A fellow with high State and local taxes would want a form 1040–T. That's the one he is looking for. He only has to find it out one time. A lawyer or a tax accountant or tax adviser could explain it to him one time, that he has got that option available to him.

That leaves about 5 percent or less of people who would still need your services. But those are people who have large amounts of money to invest. And, frankly, some fellow who is making $1 million a year—and it's my good fortune to know a few who are, thank God, it helps finance campaigns from those few who are making that much money—for a fellow like that, if he is making $1 million, he can afford to pay $25,000 a year for a lawyer or an accountant to help him with his taxes.

Do you find any appeal to that approach to resolve this thing?

Mr. BERENSON. Well, yes. I know about your discussions with Larry in this vein. I think the percentage itemizing fully might be somewhat higher. However, I think it is feasible. There is no question that with respect to a certain element of taxpayers, this could increase complexity. But you would be doing it in your search for greater equity and you could probably wind up with less complexity for the vast majority of taxpayers. Nevertheless you will have a more complex Internal Revenue Code in totality as a result of such options although individual return preparation would be simplified.

Senator LONG. Well, as far as concerns the fellow with the mortgage on the home as an example, though, you have made it much simpler for him. He doesn't have to itemize all the other things he is now itemizing. He hasn't got to keep records on his entertainment expense and all that. He is only itemizing one thing.

Mr. BERENSON. Yes.

Senator LONG. It seems to me that by taking that approach, we would make the law simpler for each group. If we were to enact this so-called flat tax, there are all kinds of people out there who would to be upset when they see what happens. I think you can see that, can't you?

Mr. BERENSON. Yes. Right.

Senator LONG. You have seen enough of their complaints already. They are going to come in and ask us to keep the complexity so that they won't be given the worst of it, and have their taxes raised by being denied the various incentives in the law that help them to do the various things they are doing.

I'm seeking answers, but it seems to me that it will be enough if we can make it simpler for the average taxpayer—the fact that it is more complicated for you accountants and lawyers, should not be too much of a bother to people. It makes me think of what Clint Murchison said when he went to build the stadium down there in Dallas. In that stadium there is a cover over all the spectators, and a great big open area in the middle, where the Sun comes through and where the rain falls, where the ballplayers are going to be. He said, "Those fellows are paid to get out in that mud and rain and fight one another." He said, "The spectators are entitled to sit in the shelter."

I don't know why we didn't make it all that simple for you highly paid accountants. It seems to me that this little fellow ought to be able to make out his own tax return.

Mr. **Berenson**. I think there is a great deal of merit and I think it's worthy of a pilot test program.

I think it's an erroneous perception that the accountants and lawyers have a vested interest in chaos and confusion. Any type of changeover to the most simple or basic will have such transitional rules in it that I think it would probably keep the accountants and lawyers so busy that it would be an unwarranted financial benefit.

I think what you are suggesting is something that should be studied. I think there may be substantial merit in it. The concern would obviously be on the deduction side if you are going to have different types of returns and the price of such simplicity is reduced benefits from itemization—in other words there are people who have entered into long-range commitments and mortgages and so forth on the assumption that they were going to have a certain after-tax cost. The classic American dream of home ownership also entailed having a mortgage that many people really had a difficulty maintaining, and when tax rates come down while the total tax paid does not due to neutrality, the reduction in the indirect Federal benefit is going to cause some economic difficulty.

So when you are talking about the revenue-deduction side, the cost of carrying existing obligations is something, I think, that has to be considered separately from a return-simplifying idea of a separate itemized deduction for those areas. But that could be achieved. And I think it's worthy of merit.

Senator **Long**. Well, Bernard Shapiro is sitting over there behind you and he is scheduled to be the last witness. He has worked with us for many years and he will tell you that when we go to simplify or streamline the code, everybody who is going to pay more taxes, even a small increase in taxes, because of the simplification, is going to be against it. All of a sudden you will find that they don't want the simplification after all. Not when they find out they are going to pay more taxes.

The people who are getting a tax cut under simplication are all for it. Obviously they like it because it's simpler; but the main thing is that they are getting a tax cut.

Now if you are going to make any major tax overhaul as some advocate that we do, you had better plan on a major revenue loss in doing it. And you are going to have to get those revenues somewhere. You are going to have to find some other revenue sources to tap. That's just what we had better all expect when we do that.

Thank you very much.

Senator **Danforth**. Senator Packwood.

Senator **Packwood**. Mr. Farnell, you indicated a 14-percent sales tax. I assume you mean a retail sales tax.

Mr. **Farnell**. Yes, sir. Some type of consumption tax.

Senator **Packwood**. Yes. It would result in the same revenues that the Treasury Department collected in 1982. Do you mean income tax revenues or do you mean all revenues?

Mr. **Farnell**. I mean income tax revenues.

Senator **Packwood**. So we would substitute that for the personal income tax?

Mr. **Farnell**. Yes, sir.

Senator **Packwood**. Corporate tax is another matter?

Mr. **Farnell**. Yes, sir.

Senator **Packwood**. Now you are assuming with that that all of the things that we now encourage with income tax incentives—home ownership, charitable contributions—because there would be no income tax—would continue on a pace as they do now?

Mr. **Farnell**. Sir, this is one of the problems with the Internal Revenue Code. Using the Internal Revenue Code not as a revenue mechanism, but as a social mechanism; whatever social or gains that the Congress desires. So if it's to be a revenue-raising item, such as what I am proposing, would be strictly a revenue item and that is all. Other matters, other social reforms should be carried out in another vehicle.

Senator **Packwood**. Well, the other vehicle, if we don't use the Tax Code, is the Government programs. We collect the taxes, and the example I have used often is home ownership.

Mr. **Farnell**. Yes, sir.

Senator **Packwood**. At the moment you want to buy or build a house, you take the deduction. If you don't have that deduction, and we still want to encourage it beyond the marketplace, then I guess the equivalent is we tax you; we collect the money; we bring it here; we give it to the Department of Housing and Urban Development; and you go down to the local HUD office, if you want to buy a house, and apply for a housing grant.

Mr. **Farnell**. Or you could exempt housing from the sales tax or the consumption tax.

Senator **Packwood**. Then you are talking about, in essence, exemptions from the sales tax anyway.

Are you suggesting that we go to a sales tax system with deductions?

Mr. **Farnell**. No, sir. I'm saying if you want to encourage home ownership and you wish to do it through the sales tax system, you completely exempt houses and homes from the sales tax. I, personally, don't advocate that.

Senator **Packwood**. The way we could exempt food.

Mr. **Farnell**. Yes, sir.

Senator **Packwood**. All right, I understand. Food or drugs, I understand that. But assuming that doesn't give you the stimulus that you want—because normally you are then talking about exclusions and therefore you are going to have to raise your percentage. And everybody is going to want an exclusion for cars, the backbone of American industry. I mean you could start going down the line of the exclusions that people will then want.

What I fear is that we are going to want to do lots of things, and if we don't do them with tax incentives, we are going to do them with Government-run programs, badly managed and overly expensive and not as efficient in achieving what we want to achieve as the use of the Tax Code for incentives.

Mr. **Farnell**. That certainly is a possibility, Senator. The problem with the Tax Code is consistency. If we quit changing it, if we quit making modifications every year, if we were consistent and left it alone, I believe it could function properly regardless of the complexity that it has.

Senator **Packwood**. I might say, Mr. Berenson, I agree with one point very much that you made in your summary. I didn't get to read your whole statement. But how many people use the 1040-EZ and the 1040-A and how relatively easy it is. And you could also add to that the 1040 for the nonitemizers who take three or four credits and that is about it.

About two-thirds of the people in this country file one of those three forms, and they are not unduly complex. And I think Senator Long's idea has some great merit. But whether you increased the zero bracket amount—there is something that most people simply chose to file a relatively simple form that they could make out not just without your help but probably without H&R Block's help. They chose to do it. And that removes, at least, the issue of complexity for the few that complain about it.

But, indeed, for most tax filers today, complexity is not a major issue. Mr. Block had testified some years ago. It was good testimony. He obviously does lots and lots of polling about what people think of the Tax Code. And he said, "complexity is very low on their list of complaints." Fairness is very high on their list of complaints. As you correctly surmise, if they confuse complexity and fairness, they may talk about one when they mean to talk about the other.

But just the sheer complexity of the Tax Code for the average wage earner is not an issue of great importance to them. And, therefore, if you reform it or make the Tax Code simpler, you may not have solved the complaint that many people have about the Tax Code, which in their mind is fairness; not complexity.

Mr. **Berenson**. Senator, that is a very valid point—and I would agree wholeheartedly with what you have just said. I think one of the things we have to focus on is that change equals complexity. We saw this when we just put in something good and proper like the zero bracket amount. And if you start taking that vast bulk of taxpayers who are working with the 1040-EZ and so forth, and just make changes, you are introducing a type of complexity that I just think would be uncalled for. So I think that dealing with the perception that what is complex must be unfair is very, very important.

Also, I think there is another thing about perceptions that is misunderstood. Basically, one of the perceptions by taxpayers is that the tax rates are too flat right now; that there is not enough spread. The erroneous conception is that the very wealthy are not paying enough in the higher income brackets. Yet we are talking about even making that differential flatter.

Senator **Packwood**. You can get that question. Any one of us gets it in the factories we go through. And we get questions about the flat tax from the average Jane or Joe working in the textile factory or working in the lumber mill.

They think that the rich escape so much taxation that if we had a flat tax, the average Jane or Joe's taxes could be lowered because we would collect all this money we are now not collecting from the rich. I mean their perception is fairness; not complexity.

If we had a genuine flat tax, I mean a real flat tax, they would be in for a rude shock because on the average everybody's income of $30,000 or less, they would pay more taxes, and everybody over, on the average, would pay less taxes. And I don't think that is what the average wage earner in this country is contemplating when they say, "I support a flat tax."

Mr. **Berenson**. Well, I think we all have the figures of some of the polls, and they have shown the public perception of how much people pay as a percentage of their income when they have income over $500,000. And it's completely misleading. One of the problems I think we all have—sometimes we get too close to the equity problems in our Tax Code. We always emphasize the negatives in our system. We always emphasize the noncompliance. Everything that comes out to the media is generally emphasizing the breakdowns in the system. And I think we have all helped foster this perception that there is a gross unfairness which exists more in the minds of many people than in reality as far as the broad majority of taxpayers are concerned.

Senator **Packwood**. Thank you.

Senator **Danforth**. Senator Boren.

Senator **Boren**. Thank you, Mr. Chairman.

Mr. Farnell, if we change to strictly a consumption oriented approach in terms of raising revenue, one of the questions I have is what would we do in terms of encouraging risk taking? We have seen some very positive results in regard to the startup industries when the capital gains were reduced and the pool of risk capital grew in the country. What impact do you think it would have on that kind of investment and whether or not it would still be made?

Mr. **Farnell**. Senator, your earnings on your new ventures would not be taxable. The income would not be taxable to the people. It would be a tremendous economic incentive. Hopefully, the funds that I am seeing now in my small practice in a town in northeast Texas—I'm seeing millions of dollars a year going out in tax shelters that have no more hope of surviving or making anything than I do of walking these walls.

These millions of dollars would go not to these uneconomical ventures but into savings. You would encourage, you would promote savings. You would have funds available in financial institutions, I believe, at a much lower rate than you have now. You would make more borrowed and equity capital more readily available to the entrepreneur.

Senator **Boren**. So you think the increased pool of savings that would result from a consumption approach on taxation, and the lowered interest rate, would more than offset. I guess I'm worried about the competing investment. Let's say the sure kind of investment versus those that involve substantial risk. And the Tax Code now, certainly, gives some incentive for risk taking that helps strike the balance a little bit more on what you might call the cutting innovative edge of our economy. While there may be opportunities for very high returns, but the percentage of your chance of getting any return at all might be much smaller.

But you would just rely on the lower interest rates?

Mr. **Farnell**. Yes, sir.

Senator **Boren**. That would be essentially what you would do?

Mr. **Farnell.** Yes, sir.

Senator **Boren.** Would there be any period of phasing in this change?

Mr. **Farnell.** Senator, there are two approaches that could be taken. The Treasury, I believe, collects somewhere in the neighborhood of $40 billion a year in delinquent taxes. If you had an immediate phase in of this consumption tax at your 14-percent level or whatever level is desired, this would equal your income taxes. The Treasury, for the next 3 to 4 years, would be collecting this $40 billion a year of revenues from prior year delinquent taxes and it would be a windfall to the Treasury. I think that would be rather drastic. I think you have already had a lot of business plans that have been made that should be seen through.

And I would think it would be more practical to have some smaller rates, some lower rates, for a period of time; gradually increasing the consumption rate, lowering the income tax rate.

Senator **Boren.** I see. Keep the present Income Tax Code in place, so to speak, with the current exemptions so that if people had made an investment decision based upon that in place and phased in your rates over a certain period of years as you phased up the sales tax.

Mr. **Farnell.** Yes, sir.

Mr. **Berenson.** Senator, I think that the risk taking aspect is very significant. Any steps that are taken that can decrease the capital formation in this country, I think, should be considered very carefully. And I don't think the studies that have come out support the conclusion that just by flattening tax rates while maintaining the same revenues by base broadening you are assured of increased capital formation. We have to take into account that there have been some learned congressional bodies that before felt that it was in the Nation's best interest to have certain tax incentives. Be it for extractive industries or independence in the oil and gas area or for low-income housing. And I think that before some of these changes are made, I think a significant economical environmental impact study has to be done because I think the possibility of the Government directly entering these areas for example as the private sector recedes due to rate decreases reducing tax benefits of risk taking will not occur. Unless there is some aspect of the Internal Revenue Code assisting from the risk factor, I don't think you would have gotten the private sector into these areas to the degree we find at present from a national perspective.

There are a lot of problems with these programs from a tax shelter aspect, but there also has been a lot of low-income housing built.

Senator **Boren.** Well, we saw a dramatic example, for example, in the formation of venture capital after the capital gains were dramatically reduced. There are all sorts of evidence, I think, of impact.

Let me ask this question, Mr. Berenson. One of the things that has concerned me has been recent studies, and they are not really fully complete—at least I have not seen any completed study—in terms of the impact of the current Tax Code on the cost of relative cost of capital, comparative cost of capital in this country and Japan, for example.

The cost of capital appears to be very significantly lower in Japan than it is—and in some areas of Western Europe—than it is in the United States. Now part of that is our high real interest rates. Obviously, that's a very big part of it.

But there has also been indication that additional cost may be tied into the Tax Code. The fact that our tax structure—we struggle with DISC, and FSC, and ISC, and other things on this committee—and they don't really lend themselves as readily to a rebate, for example, in terms of exported products, as other Tax Codes.

And that really concerns me. If we are going to be competitive in the world, obviously, management and labor have a dual interest here in getting the cost of capital down to the lowest possible level. If you can't compete on the capital ingredient, the only way you can compete then is to lower your real wage. And that would certainly be devastating for the country.

So do you have any thoughts about what we could do in terms of changing the Tax Code to make us—to impact us in a favorable way in terms of cost of capital? Either one of you.

Mr. **Berenson**. Definitely. There is a significant body of thought that the corporate income tax is the ultimate consumption tax because it's passed on to consumers. And if you are going to increase consumption taxes, you could wind up with the corporate tax—which is a two-tier concept—being a higher tax rather than a lower tax.

One of the basic things when you talk about the tax systems of our major trading partners and business competitors—be they Germany, Japan, France, or the United Kingdom—is that they either have various types of full integration or modified integration. Now we all know the corporate revenue loss problems with full integration or universal subchapter S application. However, I think that before we would embark on substantial tax reforms, more study has to be given to the potential of modified integration. There are proposals that could be worked on right now with respect to modified forms of integration that could achieve greater capital formation, free up capital and make us more competitive with our major trading partners who either have modified or full integration at present.

One of the basic complexities that we have in our entire corporate structure is the concept that the same basic transaction to our double tax system can have differing tax results at the shareholder level. You can have money coming out of a corporation from a basically similar transaction and it will either be ordinary income as a dividend taxable at 50 percent; it could be capital gains taxable at 20 percent; or it could be a nontaxable return of capital. And so much work goes in by tax lawyers and tax accountants unnecessarily in structuring transactions just to achieve one type of taxation over another. Similarly, numerous complex code sections and regulations have been enacted by the Government seeking to thwart such structuring, and so it goes. If a modified form of integration was put in so that the tax rate applied to all distributions coming out of corporations was uniform, you probably could eliminate about 16 sections of Internal Revenue Code, vastly simplify your corporate tax structure and probably free up much capital, which is now being locked away in corporations because they will get capital gains if they hold on until sale of liquidation rather than paying ordinary income taxes if they freed their capital now by distributing dividends. That money would be freed up and would increase capital formation and mobility and enhance our competitive abilities vis-a-vis our foreign trading partners.

Senator **Boren**. Would you also think that we might even eventually arrive at some sort of—and I agree with what you said in that area. That is something we ought to look at. That's in terms of the way we treat corporate earnings. And it would appear to make more capital immediately available.

Do you think we may be moving toward a combination of changes in the income Tax Code along with less total reliance on income tax as a vehicle? Perhaps a combination of more consumption taxes with a lower income tax rate that still allows us to maintain some incentives and would also be rebatable in exports. Is that reasonable to look at?

Mr. **Berenson**. Yes. I think it has already started to happen. If you look at the present tax revenue mix. The Government is a business. It's revenue stream is from corporate, individual, payroll and miscellaneous taxes. If you look at the way the mix has changed since 1960, and you see the payroll tax explosion, you see a distinct decrease on income tax reliance for transfer purposes.

The problem I see with it, though, is the same thing that we have had with depreciation, ACRS, and the investment tax credit when there are companies in a loss situation. For example, escalating payroll taxes are penalizing companies who hire people rather than mechanize further. More and more we have shifted our tax base into regressive or fixed-type taxation and less on the ability-to-pay approach. We are heading further that way, too. And I think the more we get away from the ability to pay and the more we put it into fixed costs, the less flexible we make our economic system.

Senator **Boren**. For individuals as well as the corporations.

Mr. **Berenson**. I agree with you.

Senator **Boren**. Thank you, Mr. Chairman.

Senator **Danforth**. Thank you both very much.

Our next panel is: Robert McGarrah, director of public policy, American Federation of State, County & Municipal Employees; Dallas Salisbury, president, Employee Benefit Research Institute, Washington, DC; F. Stuart Templeton, past chairman, American Supply Association, Washington, DC.

Mr. McGarrah.

STATEMENT OF ROBERT E. McGARRAH, JR., DIRECTOR OF PUBLIC POLICY, ACCOMPANIED BY IRIS LAV, ASSISTANT DIRECTOR FOR ECONOMIC POLICY, AMERICAN FEDERATION OF STATE, COUNTY & MUNICIPAL EMPLOYEES, WASHINGTON, DC

Mr. **McGarrah**. Thank you, Mr. Chairman. I am, as you say, Director of public policy for the American Federation of State, County & Municipal Employees. And I'm accompanied by Iris Lav, our assistant director for economic policy.

I would like the full text of my statement to be made a part of the record, if that is appropriate. And I would like to start by telling you that AFSCME is now the largest union in the AFL–CIO. It has over 1 million members in almost every State in the country.

And like most Americans, AFSCME members are increasingly hostile to the Federal income tax. An average AFSCME member makes about $15,000 a year right now. And all they have seen over the past 10 years or so have been tax increases and big tax breaks for wealthy Americans and big business.

The idea that people making over $200,000 a year have got an average tax cut of about $20,000 now, while people making less than $20,000 have really no break at all is just not fair. And the same goes for big business.

AFSCME members have another major concern about taxes. Their jobs, and support for Government services, depend upon fair taxes. And we have all seen the effects of the national taxpayer revolt throughout the country and also here in Washington.

Now as Vice President Mondale said yesterday in Philadelphia, it's clear that taxes are going to have to go up regardless of who wins the election. The deficits are just too dangerous, and the question is whose taxes are going to go up and which is the fairest plan.

Flat taxes, value-added taxes, and the so-called progressive consumption tax simply do not meet the test of fairness. And worse, a national sales tax or a value-added tax would likely hurt the ability of State and local governments to raise the kind of tax revenue they need to meet the ever growing responsibilities that they have assumed from the Federal Government over the past 4 years.

It is very clear that the State and local tax base is very, very tied to sales taxes, as you know.

We think that the Bradley-Gephardt fair tax approach of broadening the tax base by eliminating unproductive tax preferences, lowering and compressing the rate structure, is the best direction for real tax reform. We think it needs more study that it meets the test of fairness.

We look forward to working closely with you and the staff of the Finance Committee to seize this historic opportunity for a tax reform.

Thank you, sir.

[The prepared written statement of Mr. McGarrah follows:]

PREPARED STATEMENT OF ROBERT E. MCGARRAH, JR., DIRECTOR FOR PUBLIC POLICY, THE AMERICAN FEDERATION OF STATE, COUNTY, & MUNICIPAL EMPLOYEES

Summary

A tax increase is inevitable next year regardless of the election results. The consequences of continuing deficits in the $200 billion range are too serious to ignore, and major reductions cannot be achieved by spending cuts alone. The critical issue is how taxes are to be raised.

Working Americans are bearing a greater share of the tax burden than ever before, while wealthy individuals have enjoyed a huge tax cut under this Administration. In just the past few years, the share of federal taxes paid by corporations has fallen by half, with many profitable companies using loopholes to avoid paying taxes entirely. Fairness alone demands that the tax system be restructured to ensure that the wealthy and the corporate sector bear a greater share of the tax burden, but the need for additional revenues makes comprehensive reform even more essential. For if taxes are raised simply by increasing rates on the current loophole-ridden tax base, the distribution of the tax burden will be made even more inequitable, and the serious economic distortions the system provokes will be further worsened.

Many of the major tax reform plans being put forward would, however, make the tax system even more unfair and complex than it is now. Some would maintain its most economically-damaging aspects, and several would introduce new distortions as they eliminate old ones. Flat taxes, value added taxes and so-called "progressive consumption taxes" would all move the tax system further away from the ability-to-pay principle on which any fair tax system must rest. Value added taxes or a national sales tax could devastate the ability of state and local governments to raise sufficient revenues to support the new responsibilities they have taken over from the federal government in recent years. And progressive consumption taxes would introduce enormous new complexities into the tax system and could create significant disincentives for work effort.

The approach taken by the Bradley-Gephardt Fair Tax -- broadening the existing income tax base by eliminating unproductive tax preferences and then lowering and compressing the rate structure -- is the only one that would satisfy all the criteria for a good tax structure: equity, simplicity, and economic neutrality. (Although the Kemp-Kasten plan takes a similar approach, its retention of ACRS and its elimination of a progressive rate structure are serious drawbacks from an efficiency and equity standpoint, respectively.)

Making the change to a new tax structure will inevitably impose some transitional hardships on taxpayers who have enjoyed certain preferences under the current system. These hardships will be far less severe under the Bradley-Gephardt approach since it retains the basic framework of this system. But components of the current structure that have distorted economic-decision making and capital flows (e.g. percentage depletion and ACRS) should be eliminated regardless of any losses they may impose; taxpayers have already reaped unjustified windfall gains, and efficiency gains throughout the economy will more than compensate for hardships suffered by any one group. It may be desirable to subsidize certain economic activities, but we should recognize once and for all that the tax system is an inefficient and often completely ineffective mechanism for doing so.

Comprehensive reform along the lines of the Bradley-Gephardt Fair Tax is critically needed to achieve a tax structure that is fair, simple, and economically neutral. As we move toward reform, it is equally essential that we do nothing to add more unproductive tax loopholes to the system. The recent shortening of the capital gains holding period represents a decided step in the wrong direction in this regard. The enterprise zone legislation now under consideration by the Senate Finance Committee would add a whole new layer of tax preferences that run at cross purposes to many of those already in place. AFSCME urges the rejection of this legislation as inconsistent with all the principles underlying the growing consensus in favor of fundamental tax reform.

The American Federation of State, County and Municipal Employees submit for the record this statement on comprehensive tax reform. AFSCME is an AFL-CIO-affiliated union that represents more than one-million public employees at all levels of government.

A tax increase is inevitable next year regardless of the election results. The consequences of continuing deficits in the $200 billion range are too serious to ignore, and serious students of the federal budget understand that major reductions cannot be achieved by spending cuts alone. The critical issue is how taxes are to be raised.

Working Americans are bearing a greater share of the tax burden than ever before, while wealthy individuals have enjoyed a substantial tax cut under this Administration. When higher social security taxes and uncorrected bracket creep are taken into acount, people making less than $20,000 have enjoyed no tax cut during the last four years, while those making more than $200,000 have received an average tax cut of $20,000. At the same time that this massive tax shift within the household sector has occurred, an equally unfair one has occurred between the corporate and household sectors: the share of federal revenues provided by corporate income taxes has fallen by half since just FY 1980. Many profitable corporations pay no income taxes, and the 1982 effective tax rate of 213 large corporations studied by the Congressional Joint Committee on Taxation averaged just 16 percent.

These unfair redistributions of the tax burden are intimately related to the deficit crisis. Indeed, they are its chief cause. According to the Congressional Budget Office, tax changes enacted under this Administration account for nearly half of the deficit in the current fiscal year. Rather than imposing surtaxes on working Amercans or targeting only the tax preferences they enjoy, a fair solution to the deficit problem demands that the entire tax structure be revamped, with a special emphasis placed on closing the massive loopholes opened up in just the past few years.

Most economists, organizations, and individual American citizens agree that the time has come for an overhaul of the tax structure. At least a dozen major overhaul plans have been put forward to simplify the tax structure or make it conform to this or that economist's definition of efficiency. Many would do so, however, at the cost of making it even more inequitable than it is now. This is an unacceptable trade-off, and AFSCME will continue to oppose vigorously any tax overhaul plans that move the system away from an ability-to-pay basis. It should also be obvious that much of the dissatisfaction with the current tax system is due to a lack of public understanding of how the system works. Overhaul plans requiring complex transition rules or a radical reconceptualization of tax principles in order to find theoretically-perfect solutions to efficiency problems are therefore equally unacceptable.

The making of tax policy necessitates the balancing of objectives that are, to a certain extent, in conflict. Fortunately, there is an approach to comprehensive tax reform that promises a more equitable, simpler, and more economically neutral tax system all at the same time, while sacrificing none of these objectives entirely. That approach is the one taken by the Bradley-Gephardt Fair Tax bill--broadening the existing income tax base by eliminating unproductive tax preferences and then lowering and compressing the rate structure. Before examining the benefits of this approach, the deficiencies of the leading alternatives should also be considered.

Flat-rate Consumption Taxes: Regressive

Three of the leading proposed substitutes for the current federal tax system are value-added taxes, a federal sales tax, and the Hall-Rabushka "flat tax" plan. While the collection mechanisms of the three proposals are very different, their essence is the same: they are flat rate taxes on consumption.

As is well known, the proportion of income consumed is inversely related to the level of income. Substituting* any of these taxes for the current personal income tax would therefore result in an enormous shift of the tax burden onto low and middle income households, since with all its flaws the income tax remains mildly progressive.** In short, each of these proposals would move the tax system 180 degrees away from the ability-to-pay principle, sacrificing equity entirely to simplicity. This is an unacceptable outcome to AFSCME, and we are heartened to see indications that it is equally unacceptable to members of the Reagan Administration.***

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*Because of their equity effects alone, flat rate consumption taxes are unacceptable to most people as a substitute for the current system. Substantial interest remains, however, in using a low value-added or national sales tax as a supplement to the current system in order to raise additional revenue. This is an even worse idea. It not only continues to move the overall federal tax structure in a regressive direction, but it also heaps onto the IRS the burden of administering an additional form of taxation. In the case of the VAT, this burden would be considerable. Most important, instituting a supplemental consumption tax would, by itself, do nothing to eliminate the economic distortions contained in the current personal and corporate income taxes. In sum, a supplemental VAT would lead us to a tax structure that taken as a whole would be less equitable, more complex, and no less distorting of economic decision-making than the one we have now.

**Tax credits for low income people against value-added taxes paid and the personal exemption contained in the Hall-Rabushka plan do not alter this basic regressivity. They only fund a lighter tax burden for the very poor by placing an even higher burden on the middle class.

***For example, former Treasury Assistant Secretary Chapoton's remarks on flat taxes were reported in the February 6, 1984 Congressional Record and Treasury Secretary Regan's in the June 18, 1984 issue of Tax Notes.

Flat-Rate Consumption Taxes: An Interference with State Taxing Authority

An additional drawback of ad-valorem consumption taxes -- in either a value-added or national sales tax form -- is that they could interfere with the ability of lower levels of government to raise needed revenues. Sales taxes have traditionally been a key revenue source for state governments, and a growing number of local governments have been granted authority to levy them as well. Sales taxes accounted for 13.3 percent of total state/local revenues in 1982, exceeded only by property taxes and federal aid in importance.

Taxpayers support a balanced tax structure, one that does not rely excessivly on any one tax source. Suddenly making the sales tax a major federal revenue source could generate massive taxpayer sentiment for offsetting reductions in state and local sales taxes and would certainly generate resistance to increases that might be needed in the future. Cuts in federal aid motivated by a desire to shift more program responsibilities to state and local governments have already placed a great financial burden on these jurisdictions. Congress should not further crimp their ability to shoulder these new responsibilities by preempting a major revenue source they need to finance them.

"Progressive" Consumption Taxes: Progressive in Theory, Unworkable and Unfair in Practice

Another leading alternative to the flat rate consumption tax as a substitute for the current tax system is one that has been variously called a "progressive" consumption, expenditure, or cash-flow tax.* A progressive tax rate applied to consumption is advocated as a means of dealing with the most serious shortcoming of its flat-rate cousins--their regressivity. Its proponents assert that any desired degree of progressivity of the tax structure can be reproduced simply by manipulating tax rates. Although this is true in theory, consider what could be needed to achieve it.

To illustrate the problem, take a person who earns $400,000 a year, has an average tax rate of 25 percent,** and consumes only half his income. Under the current system he pays $100,000 in tax. Under a consumption tax it would take an *average* tax rate of 50 percent to raise $100,000 of tax on a consumption base of $200,000. Yet 50 percent is the highest *marginal* tax rate in existence now. Who can realistically expect Congress to approve the *even higher* marginal tax rates that would be needed to produce a 50 percent average rate? In short, any progressive consumption tax that is likely to see the light of day will be highly *unlikely* to contain the same degree of vertical equity as exists under the current tax structure.

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*The Hall-Rabushka plan is actually in the form of a cash-flow tax, although it is not progressive.

**Income in the form of tax-exempt interest or capital gains could lead to this result.

As for horizontal equity -- the principle that people of equal incomes should pay essentially equal taxes -- the consumption tax requires that this equality be defined on a lifetime basis. A great deal of the dissatisfaction with the current tax system is due to each taxpayer's fear that her equal-income next-door neighbor could be taking advantage of tax loopholes of which she is unaware. A tax system that assuages this important source of discontent (and tax evasion) by telling this taxpayer that it all works out in the end will not sell with the American people. Nor should it. A childless married couple earning $30,000 and saving $5000 annually does indeed have a greater ability to pay taxes than a couple with the same income forced to spend every penny for school tuition, clothes and food for two children. Forcing the second couple to pay higher taxes does not accord with most Americans' concept of tax equity, and no assertions that the first couple's savings will be taxed at death is likely to change this. It should be pointed out that even this somewhat obtuse lifetime income notion of equity depends crucially on the full taxation of gifts and bequests as if they were consumption. Yet given the recent history of the current gift and estate taxes, it is highly unrealistic to expect this outcome from the legislative process.

So much for equity. As for the second principal goal of fundamental tax restructuring--simplification--the consumption tax leaves a very great deal to be desired. The transition problems would be enormous, and the rules needed to prevent huge transitional inequities would be accordingly complex. For example, detailed reporting requirements on a massive scale would be required to prevent everyone from closing their savings accounts the day before the consumption tax went into effect so that they could reopen them and qualify for the savings deduction the next day. The American banking community, which recently put massive efforts and resources into preventing the far-simpler interest withholding requirement would undoubtedly rebel. To take another example, requiring the average homeowner to compute the "imputed net rental value" of her home would force even more people to obtain professional help in preparing their tax returns. In short, assertions that a consumption tax would be simpler to administer than the current system could only come from people who have not had to manage anything more complicated than a university economics department.

The final claim to fame of the consumption tax is its purported economic neutrality. Yet upon closer examination this turns out to mean neutrality vis-a-vis _no_ taxation.* Given the obvious need for at least some level of governmental expenditure and a means of financing it, this is not a very useful definition.

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*For example: "When a person earns a dollar, he must decide whether to consume it now or to save it for later consumption or bequest. _If there were no taxes_, this decision would be based on each person's present wants and best guess about future wants and the rate of return on savings. The personal income tax distorts this decison, because the return to saving is taxed. As a result, the income tax increases the cost of future consumption, or in other words, reduces the reward to saving." Henry Aaron and Harvey Galper, "Reforming the Tax system" in _Economic Choices: 1984_, The Brookings Institution, p.105. Emphasis added.

Most economists agree that the most economically-damaging facet of the current tax system is that the tax base has been so eroded by loopholes that marginal tax rates have to be excessively high. A comprehensive consumption tax base would allow for lower marginal rates, but so would a comprehensive income tax base. The fact of the matter is that a comprehensive consumption tax base is inherently smaller than a comprehensive income tax base, because savings are excluded. As a result, marginal tax rates have to be higher under a consumption tax to raise the same amount of revenue. As the previous example showed, the rate structure also has to be steeper to preserve the existing distribution of the tax burden. The point is this: while the tax deferral on savings inherent to the consumption tax may provide a savings incentive, the higher marginal tax rates on people working so that they can consume could prove an equally powerful disincentive to work.* In other words, the consumption tax is anything but neutral vis-a-vis labor income.

Progressive consumption taxes, in short, incorporate a concept of equity that is not going to be understood or accepted by the American people, cannot contribute to the simplified tax structure Americans want, and may well trade-off one set of economic disincentives for another. Fortunately, neither they nor their even more inequitable flat-rate counterparts are needed.

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*This would be an even more serious problem if the rates on the consumption tax had to be high enough to raise the revenue now raised by both the personal and the corporate income tax. Many consumption tax proponents advocate the abolition of the corporate income tax.

The Benefits of the Bradley-Gephardt Approach

An approach to fundamental tax reform that consists of: a) eliminating tax preferences and b) taxing this broadened base at fewer and lower progressive rates can satisfy all the criteria for a good tax system. Such a change preserves vertical equity, because rates would remain progressive and the ability of high-income people to shelter income would be substantially curtailed. Closing loopholes would also enhance horizontal equity--fewer loopholes mean far fewer tricks your equal-income but smarter neighbor can take advantage of to limit his tax bill. Reducing the number of preference items also means a far simpler tax code and easier administration -- fewer people would need to itemize deductions, and the thousand pages of code that define what kinds of investments qualify for special capital gains treatment could be eliminated. Finally, this approach to tax reform promises to reduce substantially the economic distortions imposed by the current system. Restoring a realistic linkage between economic and tax depreciation, for example, would go a long way toward eliminating the disparities between effective corporate tax rates that have so distorted capital flows in our economy recently. And while the problem of inflation-induced capital gains and devaluation of depreciation allowances would remain, it would be a much less serious problem under a system in which marginal rates had been substantially cut.

Transition Issues

Of course, any major overhaul of the tax structure will impose hardships on taxpayers who made investment and other economic decisions on the assumption that favorable tax treatment would continue. These transition problems will, however, be far less difficult to resolve under an approach to reform that retains the basic outlines of the current system than under one based on entirely new principles. For example, the Bradley-Gephardt plan would preserve most of the benefits of the mortgage interest deduction for most taxpayers, and those for whom the deduction would be worth less would enjoy an at least partially-offsetting decrease in their tax rates. Some of the proposals for a consumption tax, in contrast, would result in a vary large income tax liability at the time a home was purchased, and most of them would create huge difficulties in the transition years as taxpayers learned how to comply with "imputed rental value" concepts. In short, potential transition problems of the various overhaul plans differ considerably, and should be a factor in assessing their relative merits.

No steps taken to ease the transition to a new tax structure (e.g. phased-out deductions, prospective effective dates, etc.) can, however, alter the fact that some taxpayers will be paying higher taxes. This is as it should be. The oil industry, for example, has reaped the benefits of its tax preferences for decades in the form of both higher after-tax profitability and preferential access to capital. The fact that the value of existing oil industry assets will fall and its cost of capital rise as a result of eliminating them should not deter us from the necessary changes. These preferences have distorted capital flows in the economy, as have many of the other industry-specific tax expenditures (e.g. capital gains treatment for timber) and the Accelerated Cost Recovery System as a whole. They should be eliminated. The costs imposed on previously-favored industries will be more than offset by the improved access to capital of industries put at an artifical competitive disadvantage by the existing tax system.

Direct Subsidies, Not Tax Loopholes

This is not to say that all the preference items contained in the tax code are necessarily inappropriate. What *is* inappropriate, as more and more policy makers are coming to recognize, is for these activities to be subsidized through the tax code. For example, there are good reasons to provide federal assistance to state and local governments to help them raise funds for infrastructure projects. Rebuilding these public facilities is recognized as essential to the economic revitalization of private industry in many parts of the country, yet the ability of the state and local government sector to compete for capital at market rates is constrained by taxpayer resistance. But exempting from taxation the interest on state and local debt has proven to be an extremely costly and inefficient mechanism for providing this subsidy. Studies have shown that for every dollar state and local governments gain in the form of lower interest costs, the federal government loses two dollars of tax revenues. It would be far more efficient to provide state and local governments with the option to issue taxable debt and have the federal government reimburse a portion of the interest costs directly. While AFSCME is interested in working with other interest groups to develop such a program, we would insist that elimination of the tax exemption be irrevocably linked to this necessary subsidy. We would take a similar position vis-a-vis the elimination of the tax exempt status of unemployment benefits: Congress intended beneficiaries to enjoy a certain level of spendable income, and benefit levels must be raised if their tax-exempt status is altered.

Conclusion

In summary, AFSCME urges the members of the Senate Finance Committee to reject value-added, flat-rate, and progressive consumption taxes as inconsistent with the fair and simple tax structure that all Americans want. Base broadening plans like the Bradley-Gephardt Fair Tax proposal promise both a simpler tax system and one that remains firmly rooted in the principle of ability-to-pay. At the same time, a proposal that eliminates preference items and lowers marginal rates will reduce the distortion of economic decision-making inflicted by the loophole-ridden existing system. AFSCME urges this Committee to seriously consider this approach to comprehensive tax reform.

Comprehensive tax reform will take time. AFSCME urges this Committee to make no legislative changes in the interim that move us away from this goal. In this regard, the recent shortening of the capital gains holding period to six months represents a decided step in the wrong direction. It would be tragically inconsistent with the objectives of these hearings to add an additional layer of cross-cutting loopholes to the tax code like those contained in the enterprise zone concept. Passage of these proposals would make a mockery of the desire of a growing number of Americans for a tax system aimed exclusively at raising revenues for the necessary activities of government in the fairest, simplest, and most efficient manner possible. We desperately need an overhaul of our tax structure, but in the meantime a great deal can be done to ensure that no new problems are created.

STATEMENT OF DALLAS SALISBURY, PRESIDENT, EMPLOYEE BENEFIT RESEARCH INSTITUTE, WASHINGTON, DC

Senator DANFORTH. Mr. Salisbury.

Mr. SALISBURY. Thank you, Senator.

Tax reform, Senator, is a very appealing subject and tax reform may well be necessary. The context of the types of reforms outlined in the press release for this hearing makes it very clear that base broadening is the only real way to achieve major tax reform.

CBO, Treasury and others have clearly identified the taxation of employee benefits, pension, health, and others as the only way to sufficiently broaden the tax base to allow major tax reform. Yet I would suggest that few workers realize that benefits are at the center of major tax reform proposals. Workers do not view benefits as tax abuse. They do not know benefits are at the end of the line when one talks about flat taxes, fast taxes, or others. That lack of knowledge could be crucial to public support.

Benefits, in fact, meet the desirable criteria set forth in the committee press release in all regards praticularly the broadest based benefits. Benefits are provided at all income levels. Over 75 percent go to those earning less than $25,000. A large number of those people, obviously, belonging to AFSCME and other such organizations.

Benefits in the pension area, $80 billion paid out in benefits last year for a $50 billion tax expenditure. That relationship will become more favorable as the system matures.

Health plans paid $80 billion in benefits last year for a $17 billion tax expenditure. These are not fringes and should be clearly separated from debates over fringe benefits.

Both are largely provided because of tax incentives. In the absence of tax incentives that many of the basic tax reform proposals would eliminate, we could see tremendous damage to this economic security structure.

Tax reform is a legitimate policy objective. With very careful steps and extensive public education, there may or may not be public support for it. It must not come at the expense of economic security, and I fear that in the midst of the debate over tax reform there will be few who will be speaking for the workers of America in the benefits area since there will be a tendency by American businesses and others to look after first those tax deductions that are more crucial to their ability to function economically.

In that regard, I would suggest to the committee that the broadest and deepest consideration of these issues, as evidenced by these committees, be carried as far as possible.

Thank you, Senator.

[The prepared written statement of Mr. Salisbury follows:]

EBRI

T-36

Statement On

Tax Reform

Before the United States Senate
Committee on Finance

Hearing on Tax Reform
September 11, 1984

of

Dallas L. Salisbury*
President
Employee Benefit Research Institute

*The views expressed in this statement are solely those of Dallas Salisbury and should not be attributed to the Employee Benefit Research Institute, its officers, trustees, sponsors or other staff.

Dallas Salisbury is President of the Employee Benefit Research Institute, a non-profit, non-partisan, public policy research organization. Before joining EBRI he served in senior career policy research positions at the U.S Department of Labor and the U.S. Pension Benefit Guaranty Corporation. The work of Sophie M. Korczyk, Ph.D., Research Associate at EBRI in the preparation of this statement is gratefully acknowledged. The statement draws heavily from research studies conducted and published by EBRI.

Summary of Statement of Dallas L. Salisbury
President, Employee Benefit Research Institute

- Tax reform is an appealing concept that attracts broad based support when discussed in the context of eliminating abuse. My full statement, and a book now being published by EBRI titled Retirement Security and Tax Policy, discuss the various tax reform alternatives.

- Proposals set forth are characterized by single words: Flat, FAST, consumption, etc. Yet, few on the street fully understand what is involved in obtaining "reform" and "simplification." I hypothesize that few workers who favor "tax reform" understand that many proposals would treat non-cash compensation as taxable income. Would they be less interested in "tax reform" if they did? Action may be appropriate, but an effort should be made to assure clear public understanding if there is to be confidence in the new system.

- Revisions in the tax treatment of employee benefits considered in the context of major tax reform should include several considerations: First - distributional impact - the middle-income worker will be the major victim of any such changes. Second - progressivity desired - some treatments would be more regressive than others. Third - transition - reform would create significant reductions in public welfare and would exacerbate intergenerational tensions. Fourth - simplification - taxing benefits would actually be more complex than the current system. Fifth - the potential revenue gains from taxing benefits should be compared with additional demands that could result on the expenditure side of the budget.

- Federal, state, local and private employer-sponsored retirement plans account for 5.3 percent of total compensation. Three and one-half percent of total compensation finances employer-sponsored group health insurance. Of all full-time employees in medium and large establishments, 82 percent are covered by a pension plan. 96 percent of this group of employees are covered by health and by life insurance plans. Retirement benefit payments exceed $80 billion for a $50 billion tax expenditure, with benefits growing rapidly to complement Social Security. Benefit payments approach $80 billion for a $17 billion tax expenditure.

- The average taxpayer demanding tax reform does not see employee benefits as tax abuse. Rather, both employers and employees see these benefits as part of the social contract that defines how, with the assistance of employers, individuals provide for themselves, their families, and their future. This social contract and related tax benefits affect over 150 million Americans. In 1981, employees earning between $15,000 and $50,000 received 71.8 percent of all health-related tax preferences, 64.5 percent of all pension-related tax preferences, and 67.5 percent of all insurance-related preferences.

- Tax reform is a legitimate policy objective. We must be certain, however, that the "reform" ultimately enjoys greater public suupport than the present system. Inability to achieve this goal with major tax reform may tell us why all industrialized nations have complex tax codes.

INTRODUCTION

Mr. Chairman, I am pleased to appear before this Committee today to discuss major tax reform options and consequences for employee benefits. Employee benefits are a key element of the nation's economic security structure, and have been at the center of tax reform discussions. In a recent interview on tax reform, John Chapoton, then Assistant Secretary of the Treasury for Tax Policy was asked to define broadening the tax base. He responded:

> "A lot of income that taxpayers receive today goes untaxed--employer contributions to pension plans, health insurance, free parking, government payments, those benefits....To produce enough revenue, the flat tax would have to apply lower tax rates to more types of income with fewer deductions."[1]

To aid the Congress in considering tax reform proposals, I would like to provide some background on employee benefits, the tax benefits they receive, and the social benefits they provide (see Appendix I). In my testimony today I will discuss:

- The goals of employee benefits;
- Who receives employee benefits;
- Who receives the tax incentives for these programs; and
- The consequences of alternative major tax reform proposals for employee benefits and, therefore, economic security.

The Employee Benefit Research Institute (EBRI) was formed in 1978 as a non-profit, non-partisan, public policy research organization to conduct research and educational programs. EBRI is committed by charter to the premise that the nation is served positively in both social and economic terms by the existence of employee benefit programs; they can be clearly shown to improve economic security. We are aware, however, that there may be limits to what can and should be provided for both social and economic reasons. EBRI undertakes to provide the studies and the statistics that will allow informed priority decisions to be made based upon assessment of documented costs and benefits.

The press release on this hearing stated:

> "Our interest as a Committee is in building a tax system that will be supported by a broad consensus so that the goals of equity and efficient revenue-raising will not be undermined in the years ahead."

Our research indicates that the present tax treatment of retirement, health, and other risk related benefits meets this criterion. The current tax rules meet the Committee criteria of equity, simplicity, balance and economic efficiency. They have broad public support: Social Security, Medicare, Medicaid, employer pensions, employer health, life and disability protection work together to meet a major component of the nation's economic security needs.

These basic benefits are not "tax-ripoffs," are not viewed by the public as "abusive tax-shelters," and are far too significant to be termed "fringes." Further, consideration of the appropriate tax treatment of these benefits should be clearly separated from debates over "consumption fringes."

THE GOALS OF EMPLOYEE BENEFITS

Employer contributions for all public employer, private employer, and social employee benefits in 1982 constituted 15.8 percent of employee compensation according to Department of Commerce estimates (excludes vacation).[2] These payments constitute most workers' main source of protection against the hazards that may keep them from providing for themselves, their families, and their futures. Together, employer contributions for retirement and health programs, including Social Security and Medicare, account for 85 percent of employer payments for benefits.

Retirement Plans. Employer contributions for retirement plans total 9.0 percent of compensation. Federal, state and local and private employer-sponsored retirement plans account for 5.3 percent of total compensation. Contributions for Social Security retirement and disability benefits account for the remaining 3.7 percent.

Health Insurance. Employer contributions for health insurance account for 4.4 percent of total compensation. Of this total, 3.5 percent of total compensation finances federal, state, local and private employer-sponsored group health insurance. The remaining 0.9 percent is accounted for by employer contributions for the Medicare component of the Social Security program.

Other Risks. Employer contributions also finance unemployment insurance, worker's compensation, and life insurance. These programs protect workers and their dependents against economic uncertainty, and death. Payments for these benefits total 2.4 percent of total compensation.

Fringe Benefits. Recent debates over tax legislation have focused on other benefits in addition to the major or traditional categories. The Tax Reform Act of 1984 codified the treatment of benefits like employee discounts and subsidized cafeterias. These benefits are too small as a share of compensation for the Department of Commerce to estimate their value. According to Chamber of Commerce data, these benefits account for 0.6 percent of total compensation.

While traditional benefits make up the largest part of employee benefits, employee benefits have also begun to evolve to meet the needs of the changing work force. Census data show that over the last decade, the proportion of single-adult households with children increased by one-third. Over half of married women are now in the labor force. Single-adult and two-earner households have different benefit needs from those of the traditional single-earner, two-parent family. Many employers now provide child-care benefits, as well as flexible benefit plans that allow single-parent and two-earner families to tailor their benefits packages to meet their specific needs. Cost data on these benefits is not currently available.

WHO RECEIVES EMPLOYER SPONSORED EMPLOYEE BENEFITS?

These benefits are now provided across the income distribution. In medium and large establishments, coverage for major employee benefits is nearly universal. Employee benefits are now a mainstay of the middle-income worker's economic security, building savings as well as providing hazard protection.

Employer Pensions

Of all full-time employees in medium and large establishments, 82 percent are covered by a pension plan (table 1). Small firms, for numerous economic reasons, do not sponsor plans as uniformly. In 1981 the President's Commission on Pension Policy concluded that this could only be changed by mandating plans or by offering tax credits. As firms grow, however, they do add retirement programs. Among employees in all establishments who were covered by pensions in 1983, nearly 28 million (or 59.0 percent) earned less than $20,000 (table 2).

Pensions redistribute wealth to favor those at the lower end of the income scale who do not tend to save much out of current income. According to the EBRI/U.S. Department of Health and Human Services (HHS) May 1983 Current Population Survey (CPS) Pension Supplement, accumulated pension benefits

TABLE 1

Percent of Full-Time Employees Participating in Selected Employee Benefit Programs, Medium and Large Establishments, 1983[a]

Employee Benefit Program	Percent of Employees
Private pension plan	82
Health insurance	
employee	96
dependents	93
Life insurance	96
Long-term disability insurance	45
Sickness and accident insurance	49

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics, "Employee Benefits in Medium and Large Firms, 1983," May 1, 1984.

TABLE 2

Distribution of Employees with Pension and Health Coverage by Earnings

Earnings	Employees with Pension Coverage, 1983		Employees with Health Coverage, 1983	
	Total (in millions)	Percent	Total (in millions)	Percent
Less than $20,000	27.9	59.0	83.7	74.3
$20,000 to $49,999	18.1	38.0	26.2	23.2
$50,000 and over	1.4	2.9	2.7	2.4
Total a/	47.4	100.0	112.6	100.0

SOURCE: EBRI tabulations of U.S. Census Bureau Current Population Survey, 1983 and EBRI-HHS Current Population Survey Pension Supplement.

a/ Detail may not add to totals due to rounding. Totals include only those civilian health and pension plan participants who reported their earnings in the Survey. When those not reporting their earnings are added, coverage totals are higher.

constitute the major form of savings for more than half of all persons with pension coverage. More than 40 percent of the labor force reported no savings income in 1983 (table 3). This group's average income was $9,651, just under half the average income of those reporting some asset income. Almost half of the group reporting little or no savings income were covered by employer pensions, however. Pensions thus constituted a net increase in savings for these workers. As the Committee press release noted, assessments of pension-related tax policies should consider the net increase and redistribution of wealth that results from expanded pension coverage.

Not all retirement benefits exhibit the same income distribution patterns, however. In particular, statutory provisions aimed at encouraging individual provision for retirement differ considerably. While 59 percent of pension participants earn less than $20,000, 46.5 percent of individual retirement account (IRA) holders and 34.8 percent of those participating in Section 401(k) plans fell into this income group (table 4). Section 401(k) plans in particular follow a different income distribution from both IRAs and employer-sponsored plans. More than half of Section 401(k) plan participants earn between $20,000 and $50,000, compared with under 50 percent for both IRAs and employer-sponsored plans.

Health Insurance

Of all full-time employees in medium and large establishments, 96 percent are covered by health and by life insurance plans (table 1). Among all employees with employer-provided health coverage, 83.7 million (or 74.3 percent) earned less than $20,000, and 23.2 percent earned between $20,000 and $50,000. About 35 percent of all spending on health care that does not pass through

TABLE 3

Savings, Pension Coverage, and Income, 1983

Savings Status[a]	Employees Covered[b] (Millions)	(Percent)	Employees Not Covered (Millions)	(Percent)	Average Annual Income (Dollars)	(Percent)
No savings	18.2	19.0	20.6	21.5	$ 9,661	40.5
Some savings[c]	36.9	38.4	20.3	21.1	19,209	59.5
Total	55.1	57.4	40.9	42.6	15,338	100.0

SOURCE: Sophie M. Korczyk, Retirement Security and Tax Policy (Washington, D.C.: Employee Benefit Research Institute, forthcoming.

[a] Individuals are classified as having some savings or no savings based on whether or not they reported any asset income in response to the survey questions. Asset income includes interest, dividends, rents, and royalties.

[b] Coverage refers to public- and private-sector pension plans and includes holders of IRA or Keogh accounts.

[c] Includes individuals reporting negative asset income (i.e., decreases in asset values).

Table 4

Percent Distribution of Participation in Retirement Programs, by Earnings, 1983

Earnings	Pension Plan	401(k)	IRA
$ 1 to $19,999	59.0	34.8	46.5
$20,000 to $49,999	38.0	55.7	45.4
$50,000 and over	2.9	9.5	8.0
Number of workers (in millions)	47.4	1.9	16.7

SOURCE: EBRI tabulations of U.S. Census Bureau Current Population Survey, 1983 and EBRI-HHS Current Population Survey Pension Supplement.

government programs is now made through employer-sponsored plans.[3] Fewer than 3 percent of pension and health insurance participants earn more than $50,000.

EMPLOYEE BENEFITS AND THE TAX CODE

The tax code is a major influence in the growth of employee benefits. One effect results from provisions that allow some employer contributions and some employee contributions to finance benefits on a tax-preferred basis. Another major impact stems from the inflation-driven increases in real tax rates of the last 20 years. While statutory tax rates have been falling at most income levels, real tax rates have risen. Inflation has overwhelmed the tax rate cuts enacted over this period. To stem the erosion of real income brought about by this "bracket creep," employees have negotiated compensation packages in which benefits have played an increasingly important role. It is interesting to note, however, that this trend has abated with increasing emphasis on 401(K) salary reduction programs that are subject to FICA tax and employer attention to health care cost-containment.

Employee benefits are also now playing a major role in tax policy. As directed in the Congressional Budget Act of 1974, the President's annual budget submission to Congress lists each year's tax expenditures. These are benefits perceived to flow to certain taxpayers as a result of the statutory treatment of certain sources or uses of income.

Of the 51 tax expenditure provisions that benefit individuals, 20, or nearly 40 percent, affect the tax treatment of privately- and publicly-provided employee benefits. This seems consistent with the nation's commitment to economic security. Two provisions--those governing the tax treatment of employer-sponsored retirement plans and health insurance plans--account for nearly two-thirds of total benefit-related tax expenditures projected in the President's 1985 budget.

Employer pensions account for nearly 50 percent of benefit-related tax expenditures. There is wide disagreement, however, about the proper way to measure these costs. Tax-expenditure measures used in the federal budget process are calculated on a cash-flow or cross-sectional basis, with the taxes deferred by current pension plan participants offset against the taxes paid by current beneficiaries. Measured this way, about $0.83 out of every tax-deferred dollar appears to be lost to the Treasury.

Recent EBRI research, however, suggests that such estimates overstate the amount of revenue lost due to these provisions. Because today's pension-plan participants will have higher retirement incomes than today's retirees, they will pay more taxes in retirement. Over their lifetimes, employees now at the beginning of their pension careers will repay all but $0.25 to $0.40 of every tax-deferred dollar. As the pension system matures, the numbers and income levels of pension-plan participants and retirees will differ less than they do today. As a result, in the future, pension-related tax expenditures measured using the Treasury's approach will be much closer to lifetime estimates.[4]

From the standpoint of long term social and economic policy, however, the difference between tax exemption and tax deferral must always be noted: these programs both reduce demands on Social Security and contribute to the public consensus for Social Security (table 5).

WHO BENEFITS FROM TAX INCENTIVES?

The average taxpayer demanding tax reform does not see employee benefits as a tax abuse. Rather, both employers and employees see these benefits as part of the social contract that defines how individuals provide for

TABLE 5

How Much of Pension-Related Tax Deferrals is Lost to the Treasury?

Method Used	Taxes Lost	Taxes Deferred
Treasury Method	83%	0%
Lifetime Method:		
Nominal dollars[a]	14	86
Real dollars[b]	28	72
Discounted for interest:[c]		
at pension rate	40	60
at federal rate	36	64

SOURCE: Sophie M. Korczyk, Retirement Security and Tax Policy (Washington, D.C.: EBRI, forthcoming).

[a] Before adjusting for inflation.
[b] After adjusting for inflation.
[c] Interest rate used to discount taxes paid in retirement to the year of retirement.

themselves, their families, and their future. This social contract and related tax benefits includes the majority of the U.S. labor force.

The distribution of benefit-related tax benefits among income groups reflects the distribution of coverage and participation. In 1981, employees earning between $15,000 and $50,000 received 71.8 percent of all health-related tax preferences, 64.5 percent of all pension-related tax preferences, and 67.5 percent of all insurance-related preferences (calculations based on table 6). This group pays 51 percent of total federal taxes. By comparison, this income group received 64.2 percent of tax benefits related to homeownership. It would seem that employee benefits are less of a luxury than owning your own home.[5]

TABLE 6

Revenue Loss for Major Benefits and Taxes Paid by Income Class as Percent of Total Adjusted Gross Income Class, 1981[a]

Adjusted Gross Income Class	Exclusion of Employer Contributions for Medical Insurance & Medical Care	Exclusion of Worker's Compensation Benefits	Exclusion of Untaxed Unemployment Insurance Benefits	Exclusion of Disability Pay	Net Exclusion of Pension Contributions & Earnings[b]	Exclusion of Insurance Premiums[c]	Percent of Total Taxes Paid
Less than $10,000	6.5%	29.4%	50.6%	83.0%	4.0%	4.5%	2.6%
$ 10,000 to $ 15,000	8.7	16.6	26.4	14.4	5.6	6.1	5.7
$ 15,000 to $ 20,000	10.7	11.7	9.7	6.7	7.8	8.8	8.0
$ 20,000 to $ 30,000	28.3	24.8	12.8	2.0	22.6	24.0	20.6
$ 30,000 to $ 50,000	32.8	12.9	0.4	-	34.1	34.7	30.4
$ 50,000 to $100,000	10.6	3.5	-	-	17.8	15.2	18.1
$100,000 to $200,000	1.9	0.7	-	-	6.0	4.8	8.3
$200,000 and over	0.4	0.3	-	-	2.1	1.9	6.3

SOURCE: EBRI calculations based on U.S. Congress, Congressional Budget Office, Revising the Individual Income Tax, July 1983 (Washington, D.C.: U.S. Government Printing Office, 1983), Table 9, pp. 62 and 63.

NOTE: Percents may not add to 100.0 percent due to rounding.

[a] 1981 income levels and 1982 law.

[b] Includes the exclusion of contributions and earnings for employer plans and plans for the self employed and others.

[c] Includes premiums for group-term life insurance and accident and disability insurance.

THE TAX REFORM MOVEMENT

Tax reform is a perennial topic of discussion. At least a dozen major tax reform proposals were introduced in the 97th Congress. More tax reform proposals were introduced in the 98th Congress. Some legislative proposals call on the Treasury to study major tax reform, while others contain detailed amendments of the Internal Revenue Code. President Reagan has also asked that the Treasury department analyze basic tax reform options and prepare a report by December 1984.

At the heart of the major tax reform movement is the widespread belief that the tax system is unfair and inefficient. The middle-income taxpayer feels that he or she is paying the bill for the loopholes of the wealthy.

The tax system is considered by some to be inefficient because investment and other economic decisions are often driven as much or more by tax needs as by economic returns and productivity considerations. High marginal tax rates encourage taxpayers to seek out tax-favored sources of income--capital gains, for example--and tax-favored uses of income, such as housing.

Major tax reform proposals offer ways to restructure--not lower--the nation's tax bill. Major tax reform proposals such as the flat tax, the "fast" tax, the consumption tax, and the gross income tax, would lower marginal tax rates and expand the income tax base. These proposals would change the distribution of tax liability among individuals by eliminating many tax preferences in current law. Another set of proposals would raise additional revenue through a broad based value added or sales tax.

The arguments for broadening the tax base have attracted a wide range of political support. Conservatives support broadening the tax base as a way of eliminating the income-earning disincentives and market interference of high marginal tax rates. They also prefer individual decision-making to employer or government decisions made on the worker's behalf. In this view, Individual Retirement Accounts (IRAs) are preferable to either Social Security or employer pensions as a means of providing for retirement.

Liberals support broadening the tax base as a way of eliminating tax-code provisions perceived to benefit primarily the rich. They also prefer direct government expenditures over the tax subsidies that might arise from tax incentives.

EMPLOYEE BENEFITS IN MAJOR TAX REFORM PROPOSALS

While tax reform has broad support, it would also have widespread costs. One of the most important consequences of tax reform proposals that seek to restructure the tax system for the average taxpayer would be to change the tax treatment of employer contributions for employee benefits.[6]

Comprehensive Income Tax

A comprehensive tax attempts to tax both actual and imputed income. Many comprehensive income tax proposals include in taxable income not only cash wages but also all or most employer contributions for employee benefits on a current basis.

Consumption Tax

The consumption tax would tax all income that is spent, excluding saving from taxable income until the funds were used for consumption. The consumption tax would therefore tax all employer contributions for benefits that do not result in saving. This includes the various employee benefits that provide insurance protection, like health insurance plans, life insurance, and disability insurance. Since cash compensation would continue to be a tax-deductible cost of doing business to the employer, the employer would presumably have an incentive to offer more compensation in cash than in benefit contributions.[7]

Value-Added Tax

For any one employer, value added is the difference between receipts from sales and amounts paid for materials, supplies, and services purchased from other firms. Total value added for the entire economy is equal to total wages, salaries, interest, rents, and profits. Like the current income tax, the value-added tax could include or exclude employee benefits in the tax base.

Federal Sales Tax

A federal sales tax would have the same effect as some forms of the value-added tax. The difference is that a federal sales tax would be levied at the point of sale, while a value-added tax is imposed at each stage of production. Since a sales tax imposes tax liability on the total value of the product, it would implicitly tax employer outlays for employee benefits since these outlays are a cost of production. It would likely have little effect, however, on either employer or individual behavior regarding the provision of employee benefits.

ISSUES IN IMPLEMENTATION AND TRANSITION

This committee expressed an interest in implementation and transition issues in basic tax reform. These problems could be formidable, and even predicting them involves some uncertainty about the reactions of employers, employees, and insurers and other providers of benefits. This uncertainty arises from the fact that the availability of tax incentives for employee benefits has influenced how plans are provided and designed. For example, because employee benefits are purchased on a group basis, employers and employees can benefit from economies of scale. Therefore, a dollar spent on employee benefits by an employer buys more than would the same dollar spent by an individual. In the absence of tax incentives encouraging employer provision, the administrative structures that make group purchases cost-effective may never have been developed.

Alternative treatments for employee benefits that have been proposed include:

- Including benefit contributions in the employee's adjusted gross income;
- Eliminating employer deductions for benefit contributions;
- Capping the share of total compensation that can be provided in the form of tax-favored employee benefits;
- Imposing an excise tax on the employer's benefit contributions; and
- Imposing a value-added or national sales tax.

The issues and economic effects that arise under each approach differ considerably.

Including Benefit Contributions in Adjusted Gross Income

Most plans do not determine the costs of employee benefits on the basis of the characteristics of the individual for whom protection is being provided. These pricing structures are reasonable from employer's viewpoint given current tax treatment, since the total cost of insuring the employer's work force is not affected by the allocation of these costs among the members of the covered population. They are irrelevant to the employee who cares only about the total amount of insurance provided, and not about how the cost of this insurance is billed to the employer.

If employer contributions for benefits were taxed to the employee, the entire pricing and cost allocation structure of benefit plans could have to be revised to allocate contributions appropriately among individuals. While the average price of providing employee benefits to various employees may be uniform, the underlying cost of benefits differs widely according to the employee's age under all major benefits. Benefits for younger employees are less costly because these employees generally have lower health insurance claims, disability rates, and mortality rates. The adjustments that would be required would vary across benefits.

Pensions. Actuarial methods used in defined-benefit pension plans do not generally allocate contributions or projected benefits to individuals, determining them instead for an employee cohort based on aggregate forecasts of that cohort's future demographic and economic experience. If defined-benefit pension costs were allocated among individuals, it would become clear that financing a given retirement benefit requires a lower contribution for a younger employee than for one closer to retirement age. The contribution for the younger employee can accrue interest over a longer period of time, while the same benefit increment for an older employee has to be financed primarily out of employer contributions.

Pension costs in a defined-benefit plan may therefore be 14 times as high for an employee at age 60 as at age 30 (calculations based on table 7). Attributing an average pension contribution to each employee would create serious inequities. Older employees would be undercredited, while younger employees would be overcredited. To the extent that older employees earn more and are taxed at a higher rate than younger employees, this inequity would be compounded.

Health Insurance. Employer contributions to finance health insurance are similarly based on the total cost of insuring a particular employee group.[8] Underlying costs for health insurance can be twice as high at age 60 as they are at age 30 (calculations based on table 9). Similarly, the underlying cost of providing health insurance for women of child-bearing age is higher than the cost of insuring young, single men. In short, the average price of most employee benefits is much higher than the cost of providing benefits to some individuals and much lower for others.

Options for Alternative Tax Treatment

If employer contributions for benefits were included in the tax base, they might be treated in the same way that the Internal Revenue Code now treats employer-paid life insurance premiums for coverage in excess of $50,000. These premiums are currently included in the tax base. The cost of life insurance varies according to the individual's age. For example, at age 30, the cost of providing life insurance worth an individual's annual salary is 17 percent as large as it is at age 45, while at age 60 this cost is nearly 4 times as large (calculations based on table 7).

To avoid the inequities that would arise if all individuals were taxed on an average cost of insurance, Treasury regulations prescribe the amount of premiums to be recognized as income for individuals on the basis of age (in five-year brackets) and coverage levels. The Treasury tables use blended actuarial assumptions for men and women based on the proportions of men and women in the group of employees with coverage over $50,000 in value.

To achieve an equitable distribution of tax liability, a schedule like that governing the tax treatment of life insurance would probably have to be developed for all employee benefits. Given the Supreme Court's decision in the *Arizona v. Norris* case, such tables would probably not be differentiated by sex. Such tables could, however, be differentiated by age, family status,

TABLE 7

BENEFIT COST FACTORS FOR EMPLOYEES AT VARIOUS AGES

Age Group	Medical Cost Factor as % of Cost at Age 45-49	Defined-Benefit Cost Factor as % of Cost at Age 45-49[a]	Life Insurance Cost Factor as % of Cost at Age 45-49[b]
Under 30	80.0	23.0	17.0
30-34	80.0	33.0	17.0
35-39	80.0	48.0	33.0
40-44	80.0	69.0	50.0
45-49	100.0	100.0	100.0
50-54	112.5	146.0	170.0
55-59	125.0	216.0	250.0
60-64	160.0	323.0	383.0
65-69	225.0	c	383.0

SOURCE: Anna M. Rappaport, F.S.A. and Malcolm H. Morrison, Ph.D., The Costs of Employing Older Workers (Washington, D.C.: U.S. Senate Special Committee on Aging and the Employee Benefit Research Institute, forthcoming).

[a] Defined contribution plan costs do not vary by age.

[b] Same life insurance cost is assumed for 65 to 69 as for 60 to 64 because it is assumed that the benefits will be reduced to equal cost; regulations allow a 30 percent reduction. If benefits are not reduced, assume costs at 65-69 are about 30 percent higher. Figures assume life insurance provided is worth one times pay.

[c] Pension costs for these employees depend on the plans's design.

or both. Family status could be used to predict health insurance claims under plans that offer maternity or dependents' benefits.

Effects of Taxing Benefits

The effects of taxing benefits would vary among benefits and would depend on whether or not individuals chose to continue their coverage. If pension accruals were taxed on a current basis, saving would almost certainly decline, and would decline disproportionately among those at lower income levels who do not tend to save out of current income.

To avoid the added tax liability, many low- and moderate-income individuals would choose to do without health and other types of insurance. Research conducted by the Employee Benefit Research Institute (EBRI) and others indicates that income determines whether or not people without employer-provided health coverage purchase such coverage themselves. If employers did not provide health coverage, most low-income workers would not purchase private health insurance.[9] Since most people covered by an employer health plan are members of low- and middle-income families, employer-provided health benefits probably substantially raise rates of private health insurance coverage throughout the nonelderly population.

For those who chose to continue their insurance coverage, the impact of a tax on health insurance premiums would be regressive. While employer contributions for life and disability insurance are based on the employee's earnings, contributions for health insurance are not. As a result, the value of employer-provided coverage is a larger share of total compensation at lower income levels and the added tax payment of low-income workers would be a larger share of their income than at higher income levels. EBRI tabulations of data produced by the Congressional Budget Office (CBO) indicate that under the Administration's proposal to cap the amount of health insurance premiums that an employee can receive tax-free, those with the lowest incomes would pay more than six times as much tax as a percent of income as those with incomes above $50,000.[10]

The flatter rate structure of some major tax reform proposals would exacerbate this regressivity. Under current-law rates, the progressivity of the tax schedule offsets the effect on tax liability of the declining share of health insurance in compensation at higher income levels.

In short, whatever the criterion used for determining the cost of each employee's cost of benefits, if it targeted those individuals likely to have the highest incidence of claims, it would also target those most likely to need insurance. Since those most likely to become sick, disabled, or die would face the highest tax liability, taxing employer contributions for benefits would impose tax liability in inverse proportion to ability to pay.

Another potential effect of taxing employee benefits to the individual could be to increase the attractiveness of flexible compensation or cafeteria plans. Under flexible compensation plans, employees can elect various levels of coverage under the major types of employee benefit plans. An employee choosing a less-generous health insurance plan, for example, can "spend" the employer's cost savings on added life insurance, vacation days, or other benefits. All employees--except for those who chronically guessed wrong about their need for health insurance or other benefits--would segregate themselves into plans according to the expected value of their claims. While this is the fundamental principle behind flexible compensation plans, many employers sponsoring these plans now price the high-cost insurance options at less than the value of the claims expected under them to maintain a reasonable risk pool of participants under each option. If employees were being taxed on the value of employer contributions, however, such subsidies would probably have to stop, since they would mean that low-risk employees would be paying the tax bill for higher-risk persons. If all persons chose plans priced at the expected value of their claims, the risk-sharing inherent in group insurance plans would be eliminated.

Eliminating Employer Deductions for Employee Benefits

Some of these distributional problems could be avoided in major tax reform proposals that would include nonpension employee benefits in the tax base by eliminating employer tax deductions for them. The value-added tax could have this effect, depending on how it was designed, and some versions of the consumption tax would provide for this.

Faced with such a provision, employers who now offer benefits would probably cut them back and those who do not would probably not institute them. Some employers who offer benefits might eliminate them or continue to offer them with full employee payment. Others might forego improving their benefit packages, while still others might institute or increase employee contributions, deductibles, or copayments where appropriate. Employers are already working to reduce their benefit costs; including benefits in the tax base would clearly accelerate this process but at a social cost.[11]

The greatest impact of proposals to eliminate employer deductions for benefits would probably be on those employees who are not now covered. Most employees without benefit coverage tend to be in smaller firms and at lower income levels. As small and new firms grow and become profitable, they are more likely to incur the financial commitment involved in establishing employee benefit plans. Removing the tax deductions for employee benefits would probably make this commitment uneconomical.

Capping Employee Benefits as a Share of Total Compensation

Another alternative that has received some attention in tax policy debates--though not necessarily in the context of major tax reform--is establishing a limit on the share of total compensation that can be provided in the form of tax-favored employee benefits. Benefits provided in excess of this amount would be subject to payroll tax, income tax, or both. Under alternative proposals, the cap could cover contributions for all benefits, or pensions, welfare benefits, and so-called "fringe" benefits could all be capped separately.

Such an approach could raise its own set of problems. For example, an employer with a mature, long-tenure work force could be put at a competitive disadvantage compared with an employer with a younger work force, even if the benefits in the two firms were identical. Furthermore, a cap could act as a target that firms with less-generous benefit plans would feel compelled to meet to maintain their competitive positions. The efforts of such employers to catch up could offset the effects on employers whose benefits exceeded the cap. Such a system could also be difficult to implement for non-profit or public-sector employers, neither of which pay business profit taxes.

Of the four alternatives that tax reformers have proposed, however, only the national sales tax would offer employers and employees more flexibility than the tax cap to choose among benefits and to choose the level of coverage to be provided under major benefits. Establishing a tax cap, however, would point up the difference in the tax treatment of insurance provided under the employer's auspices compared with the treatment of insurance purchased by the individual directly. While persons without pension coverage can establish IRAs on a tax-preferred basis, those without health or other insurance pay for such protection with after-tax dollars. A tax cap combined with provisions allowing individual purchases of insurance with before-tax dollars could mitigate the detrimental effects on expansion of coverage that could result from taxing employer contributions for benefits.

An Excise Tax on Benefits

Rather than capping benefits as a share of compensation, it would be possible to impose an excise tax on all tax-favored benefits, whatever their level. This was proposed by the Treasury to this Committee in Testimony of June 1983. This would avoid creating a target benefit level for employers to reach. An excise tax, however, would have the same effect on benefits as eliminating employer deductions for benefit contributions. Employers now offering benefits would cut them back, while those without benefits would probably not institute them. The only difference between the two options would be in the tax rates they would impose. If an excise tax carried lower rates than the corporate or business taxes the firm might be paying, then the incentives to eliminate benefits would not be as strong.

A Value-Added or National Sales Tax

Instituting a national sales tax or a value-added tax would not have the same effect as a tax levied specifically on benefits. Any tax levied at the point of sale or at different stages of production would be neutral between wages and benefits as a form of compensation and thus would not change employer and employee preferences.

CONCLUSIONS AND POLICY IMPLICATIONS

Basic tax reform appeals to a broad constituency. Current and projected deficit levels pose a threat to the economy; it may be that only sweeping changes in the tax structure will allow the federal government to raise adequate revenues to eliminate this threat.

The basic tax reform movement is motivated in part by the erosion of the income tax base due to the proliferation of both business and individual tax preferences. As the Congress proceeds with these discussions, it will be confronted with representatives of almost every special interest that benefits from the 106 provisions in the code that lead to tax expenditures, and whose elimination could hurt the pocketbooks of these interest groups. One group will probably not be represented in these discussions, however. The average working person, who takes for granted the health, pension, and insurance benefits provided in his or her compensation package, almost surely does not think of employee benefits as a tax loophole.

The Congress, however, is charged with taking a perspective on these issues that transcends the concerns of special interest groups. In particular, it is essential that major tax reform debates look beyond revenue-raising considerations alone and examine the broader economic implications of eliminating incentives now built into the tax code.

Many of these incentives were designed to further social and economic goals that could not be efficiently pursued through the expenditure side of the budget. The elimination of these incentives in the name of short-term budget goals could lead to much higher costs for the federal government in the future. When compared with the costs of assuring economic security through direct federal spending, tax incentives for employee benefits may turn out to be a bargain. For example, according to Department of Commerce data, employer-based pensions now provide over half as much retirement income as the Social Security program.[12] If employer pensions were eliminated and Social Security benefits were to be increased by 50 percent, the deficit projected in the President's budget proposal would have been almost 60 percent higher. Could the economy sustain such an increase?

Tax incentives for health insurance raise similar issues. Tax expenditures attributed to the tax exemption of employer contributions to health insurance were estimated at $17.6 billion in 1984.[13] This may be a relatively low price for society to pay for a system of health insurance that may pay as much as $90 billion in benefits in 1984 and serves more than 60 percent of the population. In 1984, by comparison, federal spending for Medicare is expected to total $62.2 billion dollars; federal-state spending for Medicaid is estimated at $37.8 billion.[14] Together, these public programs finance health care services for only about 18 percent of the population.

In any revisions of the tax treatment of employee benefits, several considerations should be prominent. First - distributional impact - the middle-income worker will be the major victim of any such changes. Second - progressivity desired - some treatments would be more regressive than others. In particular, including benefit contributions in the individual's adjusted gross income is the option that would most disrupt the arrangements now used for providing benefits and could also result in the most regressive redistribution of tax liability and benefit coverage. Third - transition - would create significant reductions in public welfare and would exacerbate intergenerational tensions. Fourth - simplification - taxing benefits would actually be more complex than the current system. Finally, the potential revenue gains from taxing benefits should be compared with additional demands that could result on the expenditure side of the budget. Once such a comparison is made, the tax code could prove to be a very efficient means of encouraging private provision for individual economic security.

NOTES

[1] "Our Complex Tax Laws: Can They Be Reformed?" U.S. News and World Report, July 30, 1984.

[2] This total includes Social Security contributions; unemployment insurance; workmen's compensation; private pensions and profit-sharing plans; federal, state and local government employee retirement plans; group health insurance, group life insurance; and supplemental unemployment benefits.

[3] Unpublished EBRI estimate.

[4] For further detail on these estimates, see Sophie M. Korczyk, Retirement Security and Tax Policy (Washington, D.C.: EBRI, forthcoming), Chapter IV.

[5] EBRI calculations based on U.S Congress, Congressional Budget Office, Revising the Individual Income Tax (Washington, D.C.: U.S.Government Printing Office, 1983), Table 9.

[6] Alternative tax systems would require detailed judgments about the treatment of various sources and uses of income. Both would also create some formidable implementation and transition problems. These problems and issues are treated in detail elsewhere. For a discussion of employer pensions in basic tax reform, see Sophie Korczyk, Retirement Security and Tax Policy (Washington, D.C.: EBRI, forthcoming) and "Basic Tax Reform: Implications for Employee Benefits," EBRI Issue Brief no. 28, March, 1984. For a wide-ranging discussion of theoretical and practical issues in basic tax reform, see Dallas L. Salisbury, ed., Why Tax Employee Benefits? (Washington, D.C.: EBRI, 1984).

[7] This argument is advanced in Robert E. Hall and Alvin Rabushka, Low Tax, Simple Tax, Flat Tax (New York: McGraw-Hill Company, 1983), p. 90.

[8] In smaller plans, the cost of providing health insurance for the marginal employee is based on the average costs of insuring the insured population of that community. In larger plans, the cost of insuring the marginal employee is based on the average cost of insuring the population represented by that employer's work force. While these two methods would be likely to yield different insurance costs for any given employee, under either method the cost of insuring that employee does not represent the cost of that employee's expected claims.

[9] Deborah J. Chollet, Employer-Provided Health Benefits: Coverage, Provisions, and Policy Issues (Washington, D.C.: Employee Benefit Research Institute, 1984), p. 94. An EBRI simulation of private health insurance suggests that 56 to 87 percent of all covered workers with 1979 family income less than $15,000 would not have purchased private health insurance, if an employer had not offered and contributed to their health insurance plan.

[10] Deborah J. Chollet, *Employer-Provided Health Benefits: Coverage, Provisions and Policy Issues*, p. 100. For a discussion of taxing employer contributions to health insurance, see also "Revising the Federal Tax Treatment of Employer Contributions to Health Insurance: A Continuing Debate," EBRI *Issue Brief* no. 21, August, 1983.

[11] For a discussion of employer efforts to reduce health care costs, see "Controlling the Cost of Health Care: Recent Trends in Employee Health Plan Design," EBRI *Issue Brief* No. 23, October, 1983.

[12] In 1981, the latest year for which complete data are available, Social Security Old Age, Survivors', and Disability benefits were $138.6 billion,, while private-sector and federal, state, and local government retirement plan benefits were $73.2 billion.

[13] *Budget of the U.S. Government, Fiscal Year 1985*, Special Analysis G.

[14] Deborah J. Chollet, "Assuring Economic Security for Workers: Health, Disability, and Life Insurance Benefits," Statement before the United States Senate Finance Committee, Subcommittee on Taxation and Debt Management, Hearing on Fringe Benefits, July 26, 27, and 30, 1984.

EBRI Research Related to Major Tax Reform

Books

Deborah J. Chollet, *Employer-Provided Health Benefits: Coverage, Provisions, and Policy Issues* (Washington, D.C.: Employee Benefit Research Institute, 1984)

Sophie M. Korczyk, *Retirement Security and Tax Policy* (Washington, D.C.: EBRI, forthcoming), Chapter IV.

Dallas L. Salisbury, ed., *Why Tax Employee Benefits?* (Washington, D.C.: EBRI, 1984)

Shorter Papers

"Basic Tax Reform: Implications for Employee Benefits," EBRI *Issue Brief* no. 28, March, 1984.

"Revising the Federal Tax Treatment of Employer Contributions to Health Insurance: A Continuing Debate," EBRI *Issue Brief* no. 21, August, 1983.

"Controlling the Cost of Health Care: Recent Trends in Employee Health Plan Design," EBRI *Issue Brief* No. 23, October, 1983.

Deborah J. Chollet, "Assuring Economic Security for Workers: Health, Disability, and Life Insurance Benefits," Statement before the United States Senate Finance Committee, Subcommittee on Taxation and Debt Management, Hearing on Employee Fringe Benefits, July 26, 27, and 30, 1984.

APPENDIX I

For legislative policy assessment purposes benefits can be classified into at least nine categories:

1. legally required benefits (including employer contributions to Social Security, Medicare, unemployment insurance and workers' compensation insurance);

2. discretionary benefits that are fully taxable (primarily, payment for time not worked);

3. discretionary benefits that insure the employee against financial risks and are tax exempt (including employer contributions to health, life, and disability insurance plans);

4. discretionary benefits that help the employee meet special needs and are tax exempt (including employer contributions to child care and legal plans);

5. discretionary benefits that have traditionally been called fringes and are intended to meet employer needs and are tax exempt (including employer provision of purchase discounts, job site cafeterias, special bonuses and awards, van pools, clubs, and parking);

6. discretionary "reimbursement account" benefit programs that have been legally allowed since 1978 which allow employees to have reimbursement accounts--funded by the employer or through salary reduction--to pay expenses that fall into "statutory benefit" areas and are tax exempt (including health care reimbursement, child care reimbursement, etc.);

7. discretionary benefits that provide retirement income as a stream of payments and for which taxes are deferred until benefits are received (including employer contributions to defined benefit pension plans and to defined contribution plans which require payment in the form of an annuity);

8. discretionary benefits that provide for the deferral of salary until termination of employment, generally pay benefits as a lump sum, and for which taxes are deferred until benefits are received (including contributions to some profit sharing plans, to money purchase plans and ESOPs); and

9. discretionary benefits that provide for the deferral of salary until special needs arise (loans and hardship), or until termination of employment, generally pay benefits as a lump sum, and for which taxes are deferred until benefits are received (including contributions to some profit sharing plans, thrift-savings plans, and salary reduction plans).

During a time when there are no apparent limits on direct federal expenditures, or on "tax incentives," analysis may not need to focus on the diversity of employee benefits. During a time of apparent limitations, however, when priorities must be decided upon, careful analysis is required of each employee benefit: why each employee benefit exists.

* Taken from a statement on EMPLOYEE BENEFITS AND ECONOMIC SECURITY by Dallas L. Salisbury before the United States Senate Finance Committee Subcommittee on Taxation and Debt Management hearing on Employee Fringe Benefits, July 26, 27, and 30, 1984.

STATEMENT OF F. STUART TEMPLETON, PAST CHAIRMAN, AMERICAN SUPPLY ASSOCIATION, WASHINGTON, DC

Senator **DANFORTH**. Mr. Templeton.

Mr. **TEMPLETON**. Mr. Chairman, thank you for this opportunity to testify on behalf of the American Supply Association. I'm Stuart Templeton, immediate past chairman of the board of ASA and am a plumbing, heating, cooling, piping wholesaler from Des Moines, IA.

Our complaints on the present system of taxation are centered on the following: Complexity, uncertainty, inequality, unworkability, and counterproductivity. The Tax Code is extraordinarily complex, especially for medium-sized small businesses like ours. Complexity has in turn, bred uncertainty. Decisions are based on probability of success in defending our interpretation against IRS.

Inequality between taxpayers and between industries abound. The premise that the Tax Code is the tool for stimulating selected segments of the economy has contributed to this phenomenon. Many sections of the Tax Code are unworkable from a practical point of view. LIFO, for example, is not practical for small businesses such as ours for no better reason than it is too complicated.

Finally, there is much about our tax laws that are backwards. Business decisions are far too often driven by potential constraints or advantages in the Tax Code rather than by sound economic marketplace judgments.

ASA is very concerned that your approach in the future must be conducted with an eye to preserving the recovering and expanding economy. We hope that you will not consider changes that present risks to the economic growth, such as increasing the net tax paid by corporations and individuals.

The American Supply Association is glad that you are taking this look at the direction on tax legislation in the future. We hope that you will undertake genuine tax reform, not loophole closings, revenue enhancements or tax increases, so that we can stake out a more productive role for the Tax Code in our economy.

We admit that we are uneasy about some approaches and some consequences. We are, indeed. But we are not afraid to embark on this course and praise, you, Mr. Chairman, and this committee for your vision in doing so.

Thank you.

Senator **DANFORTH**. Thank you, sir.

[The prepared written statement of Mr. Templeton follows:]

PREPARED STATEMENT OF F. STUART TEMPLETON, AMERICAN SUPPLY ASSOCIATION

Mr. Chairman: Thank you for this opportunity to testify on behalf of the American Supply Association. I am F. Stuart Templeton, immediate past Chairman of the Board of ASA and a plumbing-heating-cooling-piping wholesaler from Des Moines, Iowa. The American Supply Association is my national association, representing almost 4,000 p-h-c-p wholesalers from almost every State in the Union. ASA has been active in Washington for the past three years, partly so that we could respond to legislation that directly affects the conduct of our businesses on a day-to-day basis, and partly so that we can represent the views of my fellow wholesalers in shaping the direction of government in its relationship with the private sector. That is why it is particularly important for us to testify here today - the direction that you, Mr. Chairman, take our tax laws is among the most crucial decisions that you will make for the future of my business.

Let me tell you more about ASA businesses in such a way that will outline our concerns about the tax code as it exists today. The American Supply Association is comprised primarily of family-owned, small businesses that often pass within the family to the succeeding generation. As distributors of plumbing-heating-cooling-piping products, our future rests with the prosperity of the housing and construction industries -- an expanding, recovering market (as now exists) is good for business. Today we are enjoying modest prosperity after having suffered greater hardship than many during the recession that we've recently experienced. At the same time however, our markets have become increasingly competitive: with new competitors replacing old competitors, with traditional wholesaling changing to meet the challenges of new retailer and manufacturer practices, and with new entities entering the marketplace. We must adapt quickly, market more effectively and manage our businesses more efficiently than ever before. Our businesses are highly labor-intensive, as opposed to capital-intensive, and of course as wholesaler-distributors, substantial inventory is the very essence of our business.

How do we evaluate the present system of taxation? Our complaints center on the following: complexity, uncertainty, inequality, unworkability and counter-productivity.

°The tax code is extraordinarily complex, especially for medium-sized small businesses like ours. Passing over the fact that competent tax advice is extremely expensive, even qualified tax advisors cannot in too many instances, know the code well enough to assist us in making solid business decisions. It is an almost hackneyed conclusion that taxes have become so complicated that only a few understand them.

°Complexity has in turn bred uncertainty. Decisions are based on probability of success in defending your interpretation against the IRS. This has necessarily created an adversarial relationship between taxpayers and tax enforcers. Not only, then, may a section of the tax code be so complex that it defies clear-cut resolution and easy decisionmaking, but there is also the anxiety of deductions honestly taken resulting in costly audits and penalties.

°Inequality between taxpayers and between industries abounds. The premise that the tax code is a tool for stimulating selected segments of the economy has contributed mightily to this phenomenon. While there may have existed some rational basis for these distinctions at some point in time, the tax laws are a compilation of these decisions made over many years. Provisions become dated yet continue to exist, frozen into law by the political strength of their recipients. As wholesaler distributors, we are more than acutely aware, for example, of a system skewed towards capital-intensive businesses compared to those that revolve around labor and inventory.

°Many sections of the tax code are unworkable from a practical point of view. For p-h-c-p wholesalers, LIFO is a case in point. LIFO is not practical for small businesses such as ours for no better reason than that it is too complicated. While LIFO is the preferred method of accounting for inventory items, only 2.5% of all wholesalers and 1.5% percent of all retailers used LIFO in 1978 - a period of lighter inflation than we have today.

°Finally, there is much about our tax laws that is backward: business decisions are far too often driven by potential constraints or advantages in the tax code rather than by sound economic, marketplace judgements. Our tax system is anathema to the free market system, often preserving outdated methods of doing business long past their time. It represents the most significant role that government takes in our day-to-day business operations and it ought to be understood that it is another form of unproductive government regulation.

Our objectives for change are complicated by the very delicate balance that the tax laws hold over the economy. We know, however, quite clearly that we want tax reform efforts targetted towards simplification, certainty, greater equality, workability and rationality. These should be the objectives of "tax reform". In recent years, "reform" has been little more than a euphemism for a tax increase or loophole closing. Ignoring for a moment our own opposition to tax increases, Congress must realize that these are short-term goals. The public has clamored for decades for real reform and that should be your target.

We would be less than candid if we sat before you today and claimed not to have our own short-term agenda. American Supply Association members want the code to assist in the preservation and perpetuation of small, family owned businesses, both through the income tax law and the gift and estate tax code. ASA would like to see the elimination of double-taxation, especially for smaller companies where the same income generating activities - the same 14 hour day - results in a tax at the corporate level and then at the personal level. ASA would like to see a major effort directed towards simplifying inventory accounting methods so that they can be used as they were intended. And, the American Supply Association would like to see you bring the tax treatment of labor-intensive industries more into line with the treatment of capital-intensive industries.

But, we are concerned most about broader issues. ASA is very concerned that your approach in the future must be conducted with an eye to preserving the recovery and expanding the economy. We hope that you will not consider changes that present risk to economic growth, such as increasing the net tax paid by corporations and individuals. The "flat tax", for example, in light of the many things we have said here today, has great appeal to many ASA members. It removes a great deal of government influence over private sector spending and tests the free-market approach that we conservatives have pushed for years. It's simple and fair and it's enforceable, eliminating the opportunity for tax manipulators to hide amid a labyrinth of tax deductions, credits and exemptions. Yet, it makes us uneasy too. The flat tax wipes off the board years of intricate, perhaps artificial, economic relationships. That destabilization could have dramatic effects on our economy. And, we are concerned that such a tax might become the natural prelude to tax increases. In short, for all that the flat tax promises, it makes us as businessmen highly vulnerable to forces not to our liking.

The American Supply Association is glad that you are taking this look at the direction of tax legislation in the future. We think that it is time to take this long-range view, if only to give perspective to the tasks at hand immediately before us. We hope you will undertake genuine tax reform -- not loophole closings, revenue enhancements or tax increases -- so that we can stake out a more productive role for the tax code in our economy.

We have said that we were uneasy about some approaches and some consequences. We are. But, we are not afraid to embark on this course and praise you, Mr. Chairman, for your vision in doing so.

Senator **Danforth**. Mr. Templeton, you said in your testimony that you support genuine tax reform and you don't think that should be confused with, among other things, loophole closing. Do you mean by that loophole closing in the sense of weeding out a whole host of specific loopholes and one at a time doesn't do the job?

Mr. **Templeton**. Well, there aren't many loopholes in my particular industry as far as myself or the fellow wholesalers that I represent. I know that there may be some perhaps.

Senator **Danforth**. One thing that we have tried to do in both 1982 and this year in the Congress is to try to raise revenue by base broadening. And by that we have made a very specific effort to try to go through the Internal Revenue Code and find as many items as we can that would pick up a few hundred million dollars maybe, and hope that that would add up to real money. And I think a lot of us feel now that that is pretty tough yardage. That we end up with a very long bill. This past bill was something like 1,300 pages long. And we end up having a lot of results that we really don't understand because it is so complex.

And I was just wondering if that is what you were concerned about in the standard approach to loophole closing. That is, that instead of finding a thousand and one loopholes to close, maybe we should go back to the beginning and really, in effect, rewrite the Internal Revenue Code.

Mr. **Templeton**. Loophole closing isn't our biggest concern, especially out in Iowa and being connected to housing for the last 3 years. We are just trying to survive if we can.

Senator **Danforth**. Yes.

Mr. **Templeton**. And just interpreting the tax laws. It seems to me that I'm talking with my attorney or my friend the banker or someone like that more than running my own business. I'm so concerned about a violation of some sort that I'm not getting the mission done that I should be doing with my business.

Senator **Danforth**. You think it's a diversion of your attention to try to keep track of everything in the Internal Revenue Code?

Mr. **Templeton**. I don't dare not do everything right. I do spend an awful lot of time, as do my company and my people, making sure we are interpreting the law correctly. The majority of our suppliers have not taken advantage of the LIFO inventory situation. They don't understand it. It's complex. These are very small businesses that I'm talking about. They average $3 or $4 million in sales. They are mom and pop operations. Maybe 15 employees. So they just don't have a lot of time to take away from surviving, as I said.

Senator **Danforth**. Senator Long.

Senator **Long**. No questions.

Senator **Danforth**. Senator Packwood.

Senator **Packwood**. No questions.

Senator **Danforth**. Gentlemen, thank you very much for being here.

Senator **Danforth**. Finally we have Mr. Shapiro and Mr. Dildine. Mr. Shapiro is the national director for tax policy of Price Waterhouse.

Mr. Shapiro, I understand this is your first return to the Finance Committee since you left the job as the Director of the Joint Committee on Taxation a few years ago. And you did an excellent job for the Congress in that role, and we are delighted to have you back.

STATEMENT OF BERNARD M. SHAPIRO, NATIONAL DIRECTOR FOR TAX POLICY, PRICE WATERHOUSE, WASHINGTON, DC, ACCOMPANIED BY LARRY L. DILDINE

Mr. SHAPIRO. Thank you very much, Senator Danforth. It certainly is a pleasure to return to the Congress. It reminds me of the days when I was here. It has been 4 years since I have left, and I miss it. Considering what you have done in the last several years, however, I think it was the right decision, but I do miss a lot of the activity. [Laughter.]

It certainly is a pleasure to be here, and I appreciate the opportunity to be able to come and present the views of Price Waterhouse before you.

As indicated, I am the national director for tax policy for Price Waterhouse. Accompanying me is Larry Dildine, who is the director for tax economics for Price Waterhouse, and who was the Deputy Director for the Treasury Department, Office of Tax Analysis prior to joining Price Waterhouse.

We feel that our long-term service in Government, with my experience on a congressional staff and Larry's experience at the Treasury Department, gives us a feel for some of the concerns that you are facing in the review of tax reform and simplification.

We are prepared to present you a summary statement, which is rather brief, and an outline, which takes into account various issues that you need to explore for simplification. We thought an outline was an appropriate format for you to focus on.

Several exhibits are attached to the outline, which I will be summarizing. These may help give you a better feel for the structure of our tax system as you explore the opportunities for tax simplification and reform.

Our principal message is that any proposal adopted by the Congress, whether it is a flat tax, consumption tax, or other simplification measures will still leave a substantial volume of the code, and much complexity will remain in the system. There is no way to avoid this problem. And yet, we wholeheartedly endorse simplification of our tax system, and we believe that it is time for the committee to review it. It is just not an easy task. We feel, however, that the Congress should not be left with the opinion that any type of a simplified structure, flat tax, consumption tax, et cetera, would result in a very simple system for all taxpayers. That just would not occur.

We have put together a booklet, entitled "Alternative Federal Tax Systems," which was submitted to each one of you when we published it. It was sent to your offices. It is an analysis of the four alternatives—the flat tax, a consumption tax, a value-added tax, and a national retail sales tax. It provides a brief description, some examples, and the pros and cons of each proposal. The booklet was prepared by Larry Dildine and his economic staff at Price Waterhouse.

Senator LONG. May I ask for a copy of that?

Mr. SHAPIRO. We have a number of copies.

Senator LONG. I don't have a copy, and I have been asking for one.

Mr. SHAPIRO. As I indicated, those were submitted to your offices a while back.

Senator LONG. You know what happens when it goes to the office?

Mr. SHAPIRO. I remember.

Senator LONG. Sometimes you see it, sometimes you don't.

Mr. SHAPIRO. I would now like to summarize the outline which is attached to your materials we submitted. It follows the summary statement. I think that a discussion of the outline may be a helpful way to approach our presentation and the way we would like to present it to you.

The first part in Roman numeral one is the tax policy goals. These are the three objectives we sometimes affectionately refer to as the "holy trinity." Equity, simplicity, and economic efficiency. Everyone seems to focus on those criteria for the tax system.

When we talk about fairness in the tax system, I think it should be made clearly that fairness means two basic things. On the one hand, it means that taxpayers feel that the tax system should be fair to them, which means that they should pay their fair share. At the same time, fairness means that there should not be the perception that higher income individuals—for example, are not paying their fair share. Thus, when the tax system provides benefits to low- and middle-class taxpayers to ensure fairness for them, at the same time, there must be the perception that the tax is to be fair to all. Consequently, the Congress makes a number of changes both for and against taxpayers to provide fairness into the system.

It is important to point out that, a fair tax would not be a simple tax, and a simple tax would not be a fair tax. One of the reasons that we have complexity is the effort to provide fairness.

We really end up with tradeoffs. Trading off fairness and simplicity in order to provide the appropriate objectives that Congress tries to measure for our tax system.

In the case of individuals, as you can see in C-1 in the outline, the two basic objectives should be equity and simplification. Efficiency is not as important in the taxation of the average wage earner.

On the other hand, in the case of businesses, the Congress should look at equity and economic efficiency. Simplicity is not as much of a major concern for most businesses because of the nature of those businesses, and the need to keep their records for business purposes. Thus, simplicity is a secondary issue for most businesses. Economic efficiency and equity are more important.

On the bottom of the outline, we look at the present tax system and current tax policy. Tax policy looks at the purpose of our tax system, which is to raise the appropriate revenues to finance our Government. And yet when we look at the tax system, we look at the fact that our tax system has been used for a number of objectives. The tax system has focused on economic, energy, health, welfare, international trade, and social objectives to provide either fairness or the appropriate incentives. Our tax structure has solved from a blend of various economic, political, and social objectives. In a sense, this process narrows the tax base. At the same time, the tax system is providing the objectives and goals the Congress has wanted to accomplish.

Next, we focus on point No. 2 on page 2. Recently, current tax policy has been focused more on economic and political pressures. The Congress had had both time pressures and budgetary restraints. And the Congress had to focus on tax law by a piecemeal approach, instead of in a comprehensive fashion. This piecemeal approach has been a major problem the last several years. The pressures that have been placed upon you have encouraged you to make a number of these piecemeal changes in trying to raise revenue, and at the same time trying to provide equity, by dealing with loopholes, abuses, and other aspects of our tax structure.

Larry Dildine is now going to focus on some of the components of our current tax system. We are going to switch off to try to make an appropriate presentation from a policy and economic perspective for you.

[The prepared written statements of Mr. Shapiro and Mr. Dildine follow:]

OUTLINE OF TESTIMONY PRESENTED BY
BERNARD M. SHAPIRO AND LARRY L. DILDINE
ON BEHALF OF PRICE WATERHOUSE
BEFORE THE SENATE FINANCE COMMITTEE

September 11, 1984

I. WHAT ARE TAX POLICY GOALS?

A. Tax policy must be tested against the objectives of equity, simplicity, and economic efficiency, but cannot meet all three criteria in each situation

  1. A fair tax would not be simple

  2. A simple tax would not be fair

B. Congressional tax-writers cannot ignore the three objectives, but must make certain trade-offs to further other social or economic goals

C. Emphasis on the three criteria depend on which type of taxpayer is under consideration

  1. For individuals, the most important considerations are equity and simplicity; efficiency is less of an issue in the taxation of wage-earners

  2. For businesses, the most important criteria are equity and a tax policy that promotes economic efficiency; simplicity is not as important a criteria because of the specific activities of most businesses and the necessary record-keeping which has required the appropriate internal and external mechanisms to deal with the complexity of the tax Code in their particular situations

II. THE PRESENT TAX SYSTEM

A. The purpose of the tax system is to distribute the costs and burdens of funding the Government and servicing the Federal debt

  1. The tax system is designed to provide the necessary revenues

    a. The broader the tax base, the lower the rates necessary to provide the revenue needed to fund the Government

        b. Narrowing of the tax base through exemptions, exclusions, deductions, and credits has been done to encourage activities (social, economic, political, energy, trade, etc.) endorsed by Congress

        c. Most past efforts to provide equity in the system have concentrated on dealing with the base of the income tax by reviewing exemptions, exclusions, and deductions for particular types of activities or classes of taxpayers, and have resulted in a system with an income tax base that is much less than total income with correspondingly higher rates

    2. Current tax policy increasingly is the result of economic and political pressures

        a. The budget/reconciliation process each year since 1981 has required the tax-writing committees to raise additional revenues to moderate deficits. In contrast to past experience, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the Deficit Reduction Act of 1984 primarily used expansion of the tax base to increase revenues

        b. These reform efforts have been legislated in short time periods, and have been forced to deal in piecemeal, rather than comprehensive, fashion with the tax Code

B. Components of the current tax system

    1. The two main components of the tax system are the tax base and the tax rates

        a. Rates -- one rate on all income would provide simplicity, while graduated rates with certain credits provide equity

        b. Base -- a broad base provides simplicity, while certain exclusions, exemptions, and deductions provide equity

2. The current tax system provides three principal types of taxes

    a. The income tax (progressive rates on most sources of income)

    b. The payroll tax (flat rate on income from wages and salaries)

    c. Excise taxes (consumption taxes with various rates on certain items)

C. There is a widespread perception that the current income tax system is unfair and unnecessarily complex

1. The progressive income tax system was designed to require that those with higher incomes pay a higher percentage of their income in taxes

2. Deductions, credits, exclusions, and exemptions were added to encourage certain social and economic objectives rather than to raise taxes and, in some cases, to balance the relative tax burdens among different classes of individual taxpayers and different types of business taxpayers

3. Prohibitions and penalties on specific activities were designed to discourage abusive or excessive sheltering of income and to enforce compliance

4. Reasons for the perception of inequity and added complexity:

    a. Offsetting tax incentives have led to a complicated tax system designed to create balance among businesses and individuals but which fosters the perception that the tax system favors certain classes of taxpayers over others

    b. Tax incentives erode the tax base and thus require higher tax rates, which lead to additional efforts to shelter income

    c. The definitions of some deductions and credits are ambiguous to many taxpayers and thus create uncertainty and are subject to abuse

    d. Rules do not apply uniformly based on the legal "fiction" of entities

    e. Recent reform efforts have added to increased complexity of the tax code

D. The "flat" tax versus the progressive income tax under the current system

  1. The payroll tax is a form of the "flat" tax

  2. Comparison of the current income tax system to the payroll tax system

    a. The income tax applies to income from all sources but has a number of exceptions, while the payroll tax has few adjustments but is applied only against wages and salaries

    b. The income tax is complex, while the payroll tax is simple

    c. While it would be possible to increase revenue by simply increasing the payroll tax and earmarking additional revenue to a separate account or the general fund to lower deficits, such an approach may not be desirable for tax and social policy reasons because it is regressive and would tend to increase the perception of unfairness

E. Current proposals for simplification

  1. Most of the "flat" tax proposals do not provide a single tax rate and would continue some of the credits, deductions, exclusions, and exemptions under current law

  2. There is a general perception that if Congress explores the "flat" tax proposals it would be extremely difficult to broaden the base to the extent proposed in those bills because of equity considerations, incentives for certain activities, and the strong political support for certain credits, deductions, exclusions, and exemptions

F. Taxable entities require specific review and analysis

1. Individuals

    a. Wage-earning individuals

    b. Individuals with investment income
        i. Investment for profits
        ii. Investment for sheltering of income

    c. Individuals with business income

    d. Items for individuals -- deductions, credits, exclusions, and exemptions
        i. Itemized vs. nonitemized deductions
        ii. Items which foster social or economic goals, e.g., the charitable deduction, the mortgage interest deduction, the medical expense deduction
        iii. Politically motivated, e.g., the deduction for state and local taxes which makes it easier for state and local governments to raise revenue

2. Business entities

    a. Sole proprietorships
    b. Partnerships
    c. Subchapter S corporations

    d. Corporations
        i. Domestic non-financial corporations
        ii. Multinational non-financial corporations
        iii. Financial entities (banks, thrift institutions, insurance companies, regulated investment companies, and real estate investment trusts)

    e. Items for businesses
        i. Deductions for ordinary and necessary business expenses
        ii. Items which foster social, economic, etc. goals -- the deduction for pension and profit-sharing plans, intangible drilling costs, the research and experimentation credit, etc.

3. Miscellaneous entities
    a. Tax-exempt organizations
    b. Cooperatives
    c. Trusts and estates
    d. Others

G. Tax Code considerations

  1. Most current reform and simplification proposals deal only with Subchapters A and B of Chapter 1 of Subtitle A of the tax Code (Attachment A)

  2. Congress still will be faced with deciding whether to review Subchapters C through U of Chapter 1 of Subtitle A, as well as the remaining Subtitles, which will still leave substantial volume and complexity in the Code

  3. Provisions that are detailed and may appear complicated could instead provide simplicity by being so specific that taxpayers clearly know what is or is not allowed

  4. Forms (Attachments B and D)

     a. 1040EZ
     b. 1040A
     c. 1040
     d. Special schedules, worksheets, etc.

H. Statistics (reflects figures for 1983 tax returns filed through April 1984)

  1. Percentage of filers who use Form 1040EZ -- 17.1

  2. Percentage of filers who use Form 1040A -- 21.1

  3. Percentage of filers who use Form 1040 -- 61.8

     a. Those who itemize -- 57.4 percent of those who file Form 1040 (35.5 percent of all taxpayers)

     b. Those who would not itemize except for home ownership -- 26.2 percent of itemizers

  4. Attachment (C) showing

     a. The percentage of all individual taxpayers who used each line of the Form 1040 in 1981

     b. The percentage of Form 1040 filers who used each form and schedule in 1981

I. Desirability of an additional tax mechanism

1. Simplification/reform efforts in general concentrate on revenue neutrality

2. Deficit pressures are likely to require Congress to raise additional revenues in 1985 and thereafter

3. Revenue-neutral tax reform may require that Congress find additional revenue from an alternative source, such as a value-added tax or a national sales tax

    a. A new tax would add complexity (a new Subtitle) to an already complex tax code
    b. A value-added tax or a national sales tax would add a substantial administrative burden

4. The tax-writing committees and Congress must determine whether the additional complexity and burdens on business and individuals would be worth the revenue from a new tax

III. RECOMMENDATIONS

A. Undertake a systematic review of the income tax without revenue considerations or a deadline

1. Method of conducting the review
   - a. The review would be led by the tax-writing committees and their staffs
   - b. The committees could solicit advice and support from the Administration, tax practitioners, academia, and business and community leaders
2. Purpose of the review
   - a. To develop a balanced legislative package (not just a study)
   - b. To build support among the public and business
3. Initial goals of a legislative package
   - a. Approximately revenue-neutral
   - b. Same relative burdens by income class (i.e., continued progressivity of the rate structure) and between individuals and businesses
   - c. Simpler for individuals
   - d. Fairer for all groups
   - e. Less intrusion in business decisions
4. Develop legislation in a number of stages
   - a. The first stage focuses on a broad group of taxpayers
   - b. There are somewhat different objectives for each group
   - c. Work primarily on the tax base first, and then adjust the rates

B. Review of the form and structure of the tax Code

1. Undertake a systematic review of the forms to illustrate the complexities and concepts of the tax Code

2. Undertake a systematic review of the structure of the tax Code, particularly as it relates to the concepts of

   a. Gross income
   b. Above-the-line deductions
   c. Adjusted gross income
   d. Itemized deductions
   e. Taxable income
   f. Tax credits

C. First stage -- Wage and salary earning households

1. This would include those individuals whose income is made up almost entirely of wages, salaries, and dividend and interest income

2. This is the largest segment of the population

3. Revise portions of Subchapters A and B -- a relatively small part of the Code

4. Focus on simplified filing and fairness questions

   a. Some complications may be necessary for fairness
      i. The two-earner deduction for married couples
      ii. Income averaging for fluctuating incomes and the special 10-year averaging provisions
      iii. Deductions for extraordinary medical expenses and casualty losses

   b. Some aspects of fairness add complexity
      i. Adding fringe benefits and other nonwage compensation to the tax base
      ii. Allowing individuals to compute the sales deduction based on receipts rather than using the sales tax tables

5. Look for changes that are both simple and fair
   a. The elimination of certain deductions and credits would allow lower rates
   b. Areas to consider:
      i. Above-the-line deductions
      ii. Itemized deductions
      iii. Credits

6. Consider limiting certain deductions that may be ambiguous or subject to abuse
   a. This is the source of much of the perception of unfairness in the tax Code
   b. Drawing "bright line" tests could give the perception of greater fairness and end ambiguity among taxpayers
   c. Examples are charitable contributions of property and certain employee business expenses

D. Second stage -- Households with substantial investment income

1. These would be individuals who in addition to wages, salaries, and dividend and interest income also have substantial additional investment income

2. This group is more likely to use the deductions, credits, exclusions, and exemptions for sheltering of their income through the following three elements of tax shelters
   a. Leverage (use of borrowed money)
   b. Deferral (accelerated deductions)
   c. Conversion (ordinary income to capital gains)

3. Objectives for this review
   a. Economic efficiency issues
      i. Incentives for saving and innovation
      ii. Use of scarce capital
      iii. Unproductive tax shelters
   b. Equity issues
      i. Differential treatment of equally productive assets
      ii. Relative tax burden on investment income as compared to wages is perceived as unfair to wage earners
      iii. Sheltering of wage and salary income

  c. Complexity is largely unavoidable
    i. Income is not always in cash
    ii. Transactions are often complicated

4. Examine the sheltering of income

  a. Compare economic effectiveness with equity objectives
  b. Consider the treatment of interest on both sides of the transaction

5. Review the treatment of capital gains

  a. The separate treatment of capital gains is a major source of complexity in the tax Code
  b. It is an important incentive for innovation and risk-taking
  c. The fairness question must take into account the effects of inflation
  d. The separate treatment of capital gains must be balanced against the goal of lowering all tax rates

6. Review the purpose and consequences of state and local tax-exempt obligations

E. Third stage -- Nonfinancial businesses

  1. This basically is the treatment of all business income, but would not concentrate on Code Subchapters which provide special treatment for certain types of financial businesses (see below)

  2. This review would examine the use by business of deductions, exclusions, exemptions, and credits

  3. Objectives of this review

    a. Economic efficiency
      i. Reduce intrusion of taxes on business decisions
      ii. Avoid directing scarce capital to less productive uses
      iii. Provide incentives where market incentives are insufficient
      iv. Incentive provisions for certain industries or types of investment may cancel each other out

b. Fairness issues
  i. There may be greatly different tax burdens among competing businesses under the current system
  ii. There may be some unintended preferences under the current system
  iii. Unreported income in the "underground economy"

4. Possible solutions

  a. Offer the business community a trade -- reductions in corporate tax rates and top individual tax rates in return for including a larger amount of business income in the tax base and a re-examination of the business credit structure

  b. Reform Subchapter C to neutralize tax considerations in reorganizations

  c. Explore ways to improve compliance for the portion of the self-employment income in the "underground economy"

  d. Investigate further the expansion of eligibility for Subchapter S, in lieu of integration or the use of a shareholder credit

F. Fourth stage -- Financial institutions and international transactions

  1. This would include a review of the special rules for financial institutions (including banks, thrift institutions, insurance companies, and regulated investment companies and real estate investment trusts), and for international transactions

  2. Examine the changing roles of these institutions in financial markets and the extent that they provide an intermediary function

  3. The same criteria applied in E. above would be applied to those institutions

G. Fifth stage -- Rates, personal exemptions, and alternative revenue sources

1. Consider adjusting the personal exemptions

    a. To adjust for inflation since the last increase
    b. To reduce the number of taxpayers
    c. To increase the tax-exempt level of income

2. Adjust individual tax rates

    a. To achieve unchanged distribution by income class
    b. To achieve revenue neutrality
    c. To preserve prior agreements on trade-offs
    d. To simplify the rate structure, if possible

3. Consider changing the revenue target

    a. Further rate reductions may be desirable to leave more taxpayers "whole"
    b. Greater revenue may be needed if spending reductions and economic growth are insufficient to close the budget deficit

4. Compare the income tax to alternatives as a supplementary revenue source

    a. The principal alternative is a value-added tax (VAT)
    b. VAT would add an entirely new Code subtitle
    c. VAT is a tax on consumption, and probably would require many exceptions for fairness
    d. Would VAT provide a fairer tax base than a reformed income tax base?
    e. There are important political considerations: can the income tax be reformed without promised rate reductions?

5. Adjust the income tax rates or add a VAT to achieve the revenue target

H. Sixth stage -- Additional simplification/reform stages

1. Tax-exempt and tax-favored organizations -- Subchapters F, T, and U
2. Estates and trusts -- Subchapter J

IV. REVIEW OF QUESTIONS POSED IN THE COMMITTEE ON FINANCE PRESS RELEASE

A. Distributional impact of base broadening/rate reduction

1. The distributional impact by income class need not be altered significantly when the rates are adjusted appropriately

2. Relief for families and low-income individuals could be provided by an increased exemption

3. A VAT to make up any revenue shortfall would reduce the progressivity of the overall system

B. Degree of progressivity

1. This should not just be a by-product of base broadening

2. This is a strictly political determination

3. The overall degree of progressivity need not be affected

C. Transition problems

1. Most can be solved by "grandfathering," or a phase-in of new provisions

2. Congress could avoid applying large changes to existing assets

3. A VAT usually ignores transition, it could have major impacts by type of business, and it is not easy to "grandfather"

D. Simplification for individuals and corporations

1. It is more feasible for individuals without major investment or business income

2. Investment and business income requires complex record-keeping, but tax planning can be reduced

E. Taxation without regard to form of business organization

1. Consider expanding the availability of Subchapter S

2. This is an objective in Subchapter C reform

ATTACHMENT A

INTERNAL REVENUE TITLE

SUBTITLE A.	Income taxes.
SUBTITLE B.	Estate and gift taxes.
SUBTITLE C.	Employment taxes.
SUBTITLE D.	Miscellaneous excise taxes.
SUBTITLE E.	Alcohol, tobacco, and certain other excise taxes.
SUBTITLE F.	Procedure and administration.
SUBTITLE G.	The Joint Committee on Taxation.
SUBTITLE H.	Financing of presidential election campaigns.
SUBTITLE I.	Trust Fund Code.

Subtitle A—Income Taxes

CHAPTER 1.	Normal taxes and surtaxes.
CHAPTER 2.	Tax on self-employment income.
CHAPTER 3.	Withholding of tax on nonresident aliens and foreign corporations.
CHAPTER 4.	Rules applicable to recovery of excessive profits on government contracts.
CHAPTER 5.	Tax on transfers to avoid income tax.
CHAPTER 6.	Consolidated returns.

CHAPTER 1—NORMAL TAXES AND SURTAXES

SUBCHAPTER A.	Determination of tax liability.
SUBCHAPTER B.	Computation of taxable income.
SUBCHAPTER C.	Corporate distributions and adjustments.
SUBCHAPTER D.	Deferred compensation, etc.
SUBCHAPTER E.	Accounting periods and methods of accounting.
SUBCHAPTER F.	Exempt organizations.
SUBCHAPTER G.	Corporations used to avoid income tax on shareholders.
SUBCHAPTER H.	Banking institutions.
SUBCHAPTER I.	Natural resources.
SUBCHAPTER J.	Estates, trusts, beneficiaries, and decedents.
SUBCHAPTER K.	Partners and partnerships.
SUBCHAPTER L.	Insurance companies.
SUBCHAPTER M.	Regulated investment companies and real estate investment trusts.
SUBCHAPTER N.	Tax based on income from sources within or without the United States.
~~SUBCHAPTER O.~~	~~Gain or loss on disposition of property.~~
SUBCHAPTER P.	Capital gains and losses.
SUBCHAPTER Q.	Readjustment of tax between years and special limitations.
SUBCHAPTER S.	Tax treatment of S corporations and their shareholders.
SUBCHAPTER T.	Cooperatives and their patrons.
SUBCHAPTER U.	General stock ownership corporations.
SUBCHAPTER V.	Title II cases.

Subchapter A—Determination of Tax Liability

Part I. Tax on individuals.
Part II. Tax on corporations.
Part III. Changes in rates during a taxable year.
Part IV. Credits against tax.
Part VI. Minimum tax for tax preferences.

PART I—TAX ON INDIVIDUALS

Sec. 1. Tax imposed.
Sec. 2. Definitions and special rules.
Sec. 3. Tax tables for individuals having taxable income of less than $20,000.
Sec. 5. Cross references relating to tax on individuals.

PART II—TAX ON CORPORATIONS

Sec. 11. Tax imposed.
Sec. 12. Cross references relating to tax on corporations.

PART III—CHANGES IN RATES DURING A TAXABLE YEAR

Sec. 15. Effect of changes.

PART IV—CREDITS AGAINST TAX

Subpart A. Nonrefundable personal credits.
Subpart B. Foreign tax credit, etc.
Subpart C. Refundable credits.
Subpart D. Business-related credits.
Subpart E. Rules for computing credit for investment in certain depreciable property.
Subpart F. Rules for computing targeted jobs credit.

Subpart A—Nonrefundable Personal Credits

Sec. 21. Expenses for household and dependent care services necessary for gainful employment.
Sec. 22. Credit for the elderly and the permanently and totally disabled.
Sec. 23. Residential energy credit.
Sec. 24. Contributions to candidates for public office.
Sec. 25. Interest on certain home mortgages.
Sec. 26. Limitation based on tax liability; definition of tax liability.

Subpart B—Foreign Tax Credit, Etc.

Sec. 27. Taxes of foreign countries and possessions of the United States; possession tax credit.
Sec. 28. Clinical testing expenses for certain drugs for rare diseases or conditions.
Sec. 29. Credit for producing fuel from a nonconventional source.
Sec. 30. Credit for increasing research activities.

Subpart C—Refundable Credits

Sec. 31. Tax withheld on wages.
Sec. 32. Earned income.
Sec. 33. Tax withheld at source on nonresident aliens and foreign corporations.
Sec. 34. Certain uses of gasoline and special fuels.
Sec. 35. Overpayments of tax.

Subpart D—Business Related Credits

Sec. 38. General business credit.
Sec. 39. Carryback and carryforward of unused credits.
Sec. 40. Alcohol used as fuel.
Sec. 41. Employee stock ownership credit.

Subpart E—Rules for Computing Credit for Investment in Certain Depreciable Property

Sec. 46. Amount of credit.
Sec. 47. Certain dispositions, etc., of section 38 property.
Sec. 48. Definitions; special rules.
Sec. 49. Termination for period beginning April 19, 1969, and ending during 1971.
Sec. 50. Restoration of credit.

Subpart F—Rules for Computing Credit for Employment of Certain New Employees

Sec. 51. Amount of credit.
Sec. 52. Special rules.

PART VI—MINIMUM TAX FOR TAX PREFERENCES

Sec. 55. Alternative minimum tax for taxpayers other than corporations.
Sec. 56. Corporate minimum tax.
Sec. 57. Items of tax preference.
Sec. 58. Rules for application of this part.

Subchapter B—Computation of Taxable Income

Part I. Definition of gross income, adjusted gross income, taxable income, etc.
Part II. Items specifically included in gross income.
Part III. Items specifically excluded from gross income.
Part IV. Determination of marital status.
Part V. Deductions for personal exemptions.
Part VI. Itemized deductions for individuals and corporations.
Part VII. Additional itemized deductions for individuals.
Part VIII. Special deductions for corporations.
Part IX. Items not deductible.
Part X. Terminal railroad corporations and their shareholders.
Part XI. Special rules relating to corporate preference items.

PART I—DEFINITION OF GROSS INCOME, ADJUSTED GROSS INCOME, TAXABLE INCOME, ETC.

Sec. 61. Gross income defined.
Sec. 62. Adjusted gross income defined.
Sec. 63. Taxable income defined.
Sec. 64. Ordinary income defined.
Sec. 65. Ordinary loss defined.
Sec. 66. Treatment of community income.

PART II—ITEMS SPECIFICALLY INCLUDED IN GROSS INCOME

Sec. 71. Alimony and separate maintenance payments.
Sec. 72. Annuities; certain proceeds of endowment and life insurance contracts.
Sec. 73. Services of child.
Sec. 74. Prizes and awards.
Sec. 75. Dealers in tax-exempt securities.
Sec. 77. Commodity credit loans.
Sec. 78. Dividends received from certain foreign corporations by domestic corporations choosing foreign tax credit.
Sec. 79. Group-term life insurance purchased for employees.
Sec. 80. Restoration of value of certain securities.
Sec. 81. Certain increases in suspense accounts.
Sec. 82. Reimbursement for expenses of moving.
Sec. 83. Property transferred in connection with performance of services.
Sec. 84. Transfer of appreciated property to political organization.
Sec. 85. Unemployment compensation.
Sec. 86. Social security and tier 1 railroad retirement benefits.
Sec. 87. Alcohol fuel credit.

PART III—ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME

Sec. 101. Certain death benefits.
Sec. 102. Gifts and inheritances.
Sec. 103. Interest on certain governmental obligations.
Sec. 104. Compensation for injuries or sickness.
Sec. 105. Amounts received under accident and health plans.
Sec. 106. Contributions by employer to accident and health plans.
Sec. 107. Rental value of parsonages.
Sec. 108. Income from discharge of indebtedness.
Sec. 109. Improvements by lessee on lessor's property.
Sec. 110. Income taxes paid by lessee corporation.
Sec. 111. Recovery of tax benefit items.
Sec. 112. Certain combat pay of members of the Armed Forces.
Sec. 113. Mustering-out payments for members of the Armed Forces.
Sec. 114. Sports programs conducted for the American National Red Cross.
Sec. 115. Income of States, municipalities, etc.
Sec. 116. Partial exclusion of dividends and interest received by individuals.
Sec. 117. Scholarships and fellowship grants.
Sec. 118. Contributions to the capital of a corporation.
Sec. 119. Meals or lodging furnished for the convenience of the employer.
Sec. 120. Amounts received under qualified group legal services plans.
Sec. 121. One-time exclusion of gain from sale of principal residence by individual who has attained age 55.
Sec. 122. Certain reduced uniformed services retirement pay.
Sec. 123. Amounts received under insurance contracts for certain living expenses.
Sec. 124. Qualified transportation provided by employer.
Sec. 125. Cafeteria plans.
Sec. 126. Certain cost-sharing payments.
Sec. 127. Educational assistance programs.
Sec. 128. Interest on certain savings certificates.
Sec. 129. Dependent care assistance programs.
Sec. 130. Cross references to other Acts.
Sec. 130. Certain personal injury liability assignments.
Sec. 131. Certain foster care payments.
Sec. 132. Certain fringe benefits.
Sec. 133. Interest on certain loans used to acquire employer securities.
Sec. 134. Cross references to other Act.

PART IV—DETERMINATION OF MARITAL STATUS

Sec. 143. Determination of marital status.

PART V—DEDUCTIONS FOR PERSONAL EXEMPTIONS

Sec. 151. Allowance of deductions for personal exemptions.
Sec. 152. Dependent defined.
Sec. 153. Cross references.

PART VI—ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

Sec. 161.	Allowance of deductions.
Sec. 162.	Trade or business expenses.
Sec. 163.	Interest.
Sec. 164.	Taxes.
Sec. 165.	Losses.
Sec. 166.	Bad debts.
Sec. 167.	Depreciation.
Sec. 168.	Accelerated cost recovery system.
Sec. 169.	Amortization of pollution control facilities.
Sec. 170.	Charitable, etc., contributions and gifts.
Sec. 171.	Amortizable bond premium.
Sec. 172.	Net operating loss deduction.
Sec. 173.	Circulation expenditures.
Sec. 174.	Research and experimental expenditures.
Sec. 175.	Soil and water conservation expenditures.
Sec. 176.	Payments with respect to employees of certain foreign corporations.
Sec. 177.	Trademark and trade name expenditures.
Sec. ~~178~~.	Depreciation or amortization of improvements made by lessee on lessor's property.
Sec. 180.	Expenditures by farmers for fertilizer, etc.
Sec. 182.	Expenditures by farmers for clearing land.
Sec. 183.	Activities not engaged in for profit.
Sec. 184.	Amortization of certain railroad rolling stock.
Sec. 185.	Amortization of railroad grading and tunnel bores.
Sec. 186.	Recoveries of damages for antitrust violations, etc.
Sec. 188.	Amortization of certain expenditures for child care facilities.
Sec. 189.	Amortization of real property construction period interest and taxes.
Sec. 190.	Expenditures to remove architectural and transportation barriers to the handicapped and elderly.
Sec. 191.	Amortization of certain rehabilitation expenditures for certified historic structures.
Sec. 192.	Contributions to black lung benefit trust.
Sec. 193.	Tertiary injectants.
Sec. 194.	Amortization of reforestation expenditures.
Sec. 194A.	Contributions to employer liability trusts.
Sec. 195.	Start-up expenditures.
Sec. 196.	Deduction for certain unused business credits.

PART VII—ADDITIONAL ITEMIZED DEDUCTIONS FOR INDIVIDUALS

Sec. 211.	Allowance of deductions.
Sec. 212.	Expenses for production of income.
Sec. 213.	Medical, dental, etc., expenses.
Sec. 215.	Alimony, etc., payments.
Sec. 216.	Deduction of taxes, interest, and business depreciation by cooperative housing corporation tenant-stockholder.
Sec. 217.	Moving expenses.
Sec. 219.	Retirement savings.
Sec. 221.	Deduction for two-earner married couples.
Sec. 222.	Adoption expenses.
Sec. 223.	Cross references.

PART VIII—SPECIAL DEDUCTIONS FOR CORPORATIONS

Sec. 241.	Allowance of special deductions.
Sec. 243.	Dividends received by corporations.
Sec. 244.	Dividends received on certain preferred stock.
Sec. 245.	Dividends received from certain foreign corporations.
Sec. 246.	Rules applying to deductions for dividends received.
Sec. 246A.	Dividends received deduction reduced where portfolio stock is debt financed.
Sec. 247.	Dividends paid on certain preferred stock of public utilities.
Sec. 248.	Organizational expenditures.
Sec. 249.	Limitation on deduction of bond premium on repurchase.
Sec. 250.	Certain payments to the National Railroad Passenger Corporation.

PART IX—ITEMS NOT DEDUCTIBLE

Sec. 261.	General rule for disallowance of deductions.
Sec. 262.	Personal, living, and family expenses.
Sec. 263.	Capital expenditures.
Sec. 264.	Certain amounts paid in connection with insurance contracts.
Sec. 265.	Expenses and interest relating to tax-exempt income.
Sec. 266.	Carrying charges.
Sec. 267.	Losses, expenses, and interest with respect to transactions between related taxpayers.
Sec. 268.	Sale of land with unharvested crop.
Sec. 269.	Acquisitions made to evade or avoid income tax.
Sec. 269A.	Personal service corporations formed or availed of to avoid or evade income tax.
Sec. 269B.	Stapled entities.
Sec. 271.	Debts owed by political parties, etc.
Sec. 272.	Disposal of coal or domestic iron ore.
Sec. 273.	Holders of life or terminable interest.
Sec. 274.	Disallowance of certain entertainment, etc., expenses.
Sec. 275.	Certain taxes.
Sec. 276.	Certain indirect contributions to political parties.
Sec. 277.	Deductions incurred by certain membership organizations in transactions with members.
Sec. 278.	Capital expenditures incurred in planting and developing citrus and almond groves; certain capital expenditures of farming syndicates.
Sec. 279.	Interest on indebtedness incurred by corporation to acquire stock or assets of another corporation.
Sec. 280.	Certain expenditures incurred in production of films, books, records, or similar property.
Sec. 280A.	Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.
Sec. 280B.	Demolition of structures.
Sec. 280C.	Certain expenses for which credits are allowable.
Sec. 280D.	Portion of Chapter 45 taxes for which credit or refund is allowable under Section 6429.
Sec. 280E.	Expenditures in connection with the illegal sale of drugs.
Sec. 280F.	Limitation on investment tax credit and depreciation for luxury automobiles; limitation where certain property used for personal purposes.
Sec. 280G.	Golden parachute payments.

Subchapter O—Gain or Loss on Disposition of Property

Part I. Determination of amount of and recognition of gain or loss.
Part II. Basis rules of general application.
Part III. Common nontaxable exchanges.
Part IV. Special rules.
Part V. Changes to effectuate F. C. C. policy.
Part VI. Exchanges in obedience to S. E. C. orders.
Part VII. Wash sales of stock or securities.
Part VIII. Distributions pursuant to Bank Holding Company Act of 1956.

PART I—DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS

Sec. 1001. Determination of amount of and recognition of gain or loss.
Sec. 1002. Recognition of gain or loss [repealed].

PART II—BASIS RULES OF GENERAL APPLICATION

Sec. 1011. Adjusted basis for determining gain or loss.
Sec. 1012. Basis of property—cost.
Sec. 1013. Basis of property included in inventory.
Sec. 1014. Basis of property acquired from a decedent.
Sec. 1015. Basis of property acquired by gifts and transfers in trust.
Sec. 1016. Adjustments to basis.
Sec. 1017. Discharge of indebtedness.
Sec. 1018. Adjustment of capital structure before September 22, 1938. [repealed]
Sec. 1019. Property on which lessee has made improvements.
Sec. 1021. Sale of annuities.
Sec. 1023. Carryover basis for certain property acquired from a decedent dying after December 31, 1976.
Sec. 1024. Cross references.

PART III—COMMON NONTAXABLE EXCHANGES

Sec. 1031. Exchange of property held for productive use or investment.
Sec. 1032. Exchange of stock for property.
Sec. 1033. Involuntary conversions.
Sec. 1034. Rollover of gain on sale of principal residence.
Sec. 1035. Certain exchanges of insurance policies.
Sec. 1036. Stock for stock of same corporation.
Sec. 1037. Certain exchanges of United States obligations.
Sec. 1038. Certain reacquisitions of real property.
Sec. 1039. Certain sales of low-income housing projects.
Sec. 1040. Transfer of certain farm, etc., real property.
Sec. 1041. Transfers of property between spouses or incident to divorce.
Sec. 1042. Sales of stock to employees.

PART IV—SPECIAL RULES

Sec. 1051. Property acquired during affiliation.
Sec. 1052. Basis established by the Revenue Act of 1932 or 1934 or by the Internal Revenue Code of 1939.
Sec. 1053. Property acquired before March 1, 1913.
Sec. 1054. Certain stock of Federal National Mortgage Association.
Sec. 1055. Redeemable ground rents.
Sec. 1056. Basis limitation for player contracts transferred in connection with the sale of a franchise.
Sec. 1057. Election to treat transfer to foreign trust, etc., as taxable exchange.
Sec. 1058. Transfers of securities under certain agreements.
Sec. 1059. Corporate shareholder's basis in stock reduced by nontaxed portion of extraordinary dividends.
Sec. 1060. Cross references.

Subchapter P—Capital Gains and Losses

Part I. Treatment of capital gains.
Part II. Treatment of capital losses.
Part III. General rules for determining capital gains and losses.
Part IV. Special rules for determining capital gains and losses.
Part V. Special rules for bonds and other debt instruments.

PART I—TREATMENT OF CAPITAL GAINS

Sec. 1201. Alternative tax.
Sec. 1202. Deduction for capital gains.

PART II—TREATMENT OF CAPITAL LOSSES

Sec. 1211. Limitation on capital losses.
Sec. 1212. Capital loss carrybacks and carryovers.

PART III—GENERAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

Sec. 1221. Capital asset defined.
Sec. 1222. Other terms relating to capital gains and losses.
Sec. 1223. Holding period of property.

PART IV—SPECIAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

Sec. 1231. Property used in the trade or business and involuntary conversions.
Sec. 1233. Gains and losses from short sales.
Sec. 1234. Options to buy or sell.
Sec. 1234A. Gains or losses from certain terminations.
Sec. 1235. Sale or exchange of patents.
Sec. 1236. Dealers in securities.
Sec. 1237. Real property subdivided for sale.
Sec. 1238. Amortization in excess of depreciation.
Sec. 1239. Gain from sale of depreciable property between certain related taxpayers.
Sec. 1241. Cancellation of lease or distributor's agreement.
Sec. 1242. Losses on small business investment company stock.
Sec. 1243. Loss of small business investment company.
Sec. 1244. Losses on small business stock.
Sec. 1245. Gain from dispositions of certain depreciable property.
Sec. 1246. Gain on foreign investment company stock.
Sec. 1247. Election by foreign investment companies to distribute income currently.
Sec. 1248. Gain from certain sales or exchanges of stock in certain foreign corporations.
Sec. 1249. Gain from certain sales or exchanges of patents, etc., to foreign corporations.
Sec. 1250. Gain from dispositions of certain depreciable realty.
Sec. 1252. Gain from disposition of farm land.
Sec. 1253. Transfers of franchises, trademarks, and trade names.
Sec. 1254. Gain from disposition of interest in oil, gas, or geothermal property.
Sec. 1255. Gain from disposition of section 126 property.
Sec. 1256. Section 1256 contracts marked to market.

PART V—SPECIAL RULES FOR BONDS AND OTHER DEBT INSTRUMENTS

Subpart A.	Original issue discount.
Subpart B.	Market discount.
Subpart C.	Discount on short-term obligations.
Subpart D.	Miscellaneous provisions.

Subpart A—Original Issue Discount

Sec. 1271.	Treatment of amounts received on retirement or sale or exchange of debt instruments.
Sec. 1272.	Current inclusion in income of original issue discount.
Sec. 1273.	Determination of amount of original issue discount.
Sec. 1274.	Determination of issue price in the case of certain debt instruments issued for property.
Sec. 1275.	Other definitions and special rules.

Subpart B—Market Discount on Bonds

Sec. 1276.	Disposition gain representing accrued market discount treated as ordinary income.
Sec. 1277.	Deferral of interest deduction allocable to accrued market discount.
Sec. 1278.	Definitions and special rules.

Subpart C—Discount on Short-Term Obligations

Sec. 1281.	Current inclusion in income of discount on certain short-term obligations.
Sec. 1282.	Deferral of interest deduction allocable to accrued discount.
Sec. 1283.	Definitions and special rules.

Subpart D—Miscellaneous Provisions

Sec. 1286.	Tax treatment of stripped bonds.
Sec. 1287.	Denial of capital gain treatment for gains on certain obligations not in registered form.
Sec. 1288.	Treatment of original issue discount on tax-exempt obligations.

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ATTACHMENT B

Department of the Treasury
Internal Revenue Service

1983

Package X

Informational Copies of Federal Tax Forms

Please Use Form 1040EZ

During 1983 tax practitioners prepared over 1,000,000 returns on Form 1040A and over 350,000 returns on Form 1040 that could have been prepared on Form 1040EZ. We urge you to prepare the shortest form consistent with your client's tax situation. This will enable the Internal Revenue Service to process returns more quickly and at a lower cost.

Abusive Tax Shelters

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) added new penalties for promoting abusive tax shelters. The Service is stepping up its efforts to identify and take action against abusive tax shelters. We are also actively pursuing the application of the injunctive relief provisions against promoters of abusive tax shelters.

Late-filing Penalties

Please remind your clients that they can avoid penalties for late filing by sending in their return by the due date even if they are unable to send in their full tax payment at that time. However, this will not relieve them of interest or late payment penalties that may be charged.

Penalty Under the Tax Equity and Fiscal Responsibility Act of 1982

See page 1 for an important message regarding the penalty for aiding in an understatement of tax liability.

Backup Withholding

Please remind your clients that in addition to being required to report all their taxable income, they must supply their correct taxpayer identification number to their payers of interest, dividends, commissions, etc. Otherwise, backup withholding may apply starting in 1984, and certain other penalties may apply.

The Following Forms, Instructions, and Schedules Have Been Added to Package X:

Form W-3G, Transmittal of Certain Information Returns

Form W-9, Payer's Request for Taxpayer Identification Number

Form 1040-ES, Estimated Tax for Individuals

Schedule D (Form 1065), Capital Gains and Losses

Schedule K (Form 1065), Partners' Shares of Income, Credits, Deductions, etc

Form 1099-B, Statement for Recipients of Proceeds from Broker or Barter Exchange Transactions

Form 1099-MISC, Statement for Recipients of Miscellaneous Income

Form 1099-OID, Statement for Recipients of Original Issue Discount

Form 2848, Power of Attorney and Declaration of Representative

Form 5498, Individual Retirement Arrangement Information

Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips

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Description of Some Principal Federal Tax Forms

W–2 (1983) (6-part form)

Wage and Tax Statement (For Use in Cities and States Authorizing Combined Form).

Used to report wages, tips and other compensation, third-party sick pay, allocated tips, employee FICA tax, income tax withheld, state or city income tax withheld, and to support credit shown on individual income tax return.

Emp.-IRC sec. 6051; Regs. secs. 1.6041-2 and 31.6051-1; Circular E

W–2c

Statement of Corrected Income and Tax Amounts.

Used to correct previously filed Forms W-2, W-2P, W-2AS, W-2GU, and W-2VI.

Emp.-IRC sec. 6051; Regs. sec. 1.6041-2 and 31.6051-1

W–2P (1983)

Statement For Recipients of Annuities, Pensions, Retired Pay, or IRA Payments.

Used to report annuities, pensions, and retirement pay; Federal and state income tax withheld.

Emp.-IRC sec.3405; Circular E

W–3 (1983)

Transmittal of Income and Tax Statements.

Used by employers and other payers to transmit wage and income tax withheld statements (Forms W-2 and W-2P).

Emp.-IRC sec. 6011; Regs. sec. 31.6051-2

W–3G (1983)

Transmittal of Certain Information Returns.

Used by payers of gambling winnings to transmit Form W-2G to Service Centers. Also used by payers of total distributions (those that close the account) from a pension plan, annuity, or individual retirement arrangement to transmit Form 1099R to Service Centers.

IT-IRC 3402(q), 3405, 6041, 6047, 402, and 408.

W–4 (Rev. 1-84)

Employee's Withholding Allowance Certificate.

Filed by employee with employer so that proper amount of income tax can be withheld from wages. Also used by employee to certify that he or she had no liability for income tax for preceding tax year and anticipates that no liability will be incurred for current tax year (qualifying employee will then be exempt from Federal income tax withholding).

Emp.-IRC secs. 3402(f), 3402(i), 3402(m), 3402(n); Regs. secs. 31.3402(f)(5)-1, 31.3402(n)-1; Circular E

W–5 (1984)

Earned Income Credit Advance Payment Certificate.

Used by employee to request employer to furnish advance payment of earned income credit with the employee's pay.

Emp.-IRC sec. 3507

W–9 (October 1983)

Payer's Request for Taxpayer Identification Number

Used by a payer of interest, dividends, or other payments to request payee's identification number. Payees may use this form to certify that their taxpayer identification number is correct and/or that they are not subject to backup withholding. Obsoletes Form 3435, Payer's Request for Identifying Number.

IRC secs. 3406 and 6109

706 (Rev. 11-81)

(For decedents dying before Jan. 1, 1982)

706 (Rev. 12-83 expected rev. date)

(For decedents dying after Dec. 31, 1981)

United States Estate Tax Return.

Used for the estate of a deceased United States resident or citizen.

E&G-IRC sec. 6018; Regs. sec. 20.6018-1; Separate instructions

709 (Rev. 12-83 expected rev. date)

United States Gift Tax Return.

Used to report gifts made after Dec. 31, 1981, in excess of $10,000, and gifts of a future interest in property regardless of value.

E&G-IRC sec. 6019; Regs. sec. 25.6019-1; Separate instructions

709–A (Rev. 7-82)

United States Short Form Gift Tax Return.

Used by married couples to report nontaxable gifts of $20,000 or less per donee.

E&G-IRC sec. 2513; Regs. sec. 25.2513-2

712 (Rev. 9-83)

Life Insurance Statement.

Used with Form 706 or Form 709.

E&G-IRC secs. 6001 and 6018; Regs. secs. 20.6001-1, 20.6018-4(d), 25.6001-1

940 (1983)

Employer's Annual Federal Unemployment Tax Return.

Used by employers to report FUTA tax. A two-part set containing an original and duplicate copy of Form 940, with instructions for preparation.

Emp.-IRC sec. 6011; IRC Chapter 23; Regs. sec. 31.6011(a)-3; Circular E

941c (Rev. 7-82)

Statement to Correct Information Previously Reported on the Employer's Federal Tax Return.

Used to correct FICA wage, FICA tax and income tax reports previously submitted by employers.

Emp.-IRC Chapter 21; Regs. secs. 31.6011(a)-1, 31.6205-1; 31.6402(a)-2; Circulars A and E

943 (1983)

Employer's Annual Tax Return for Agricultural Employees.

Used by agricultural employers to report FICA and income taxes withheld.

Emp.-IRC secs. 3101, 3111 and 3402; Regs. sec. 31.6011(a)-1; Circular A

990 (1983)

Return of Organization Exempt From Federal Income Tax (Except Private Foundation).

Used by organizations exempt under IRC section 501(a) and described in section 501(c) other than private foundations. (An information return).

IT-IRC sec. 6033; Regs. sec. 1.6033-1(a)(2); Separate instructions

Schedule A (Form 990) (1983)

Organization Exempt Under 501(c)(3) (Supplementary Information).

Used by organizations described in IRC section 501(c)(3) (other than private foundations filing Form 990-PF).

IT-IRC sec. 6033; Separate instructions

990–C (1983)

Farmers' Cooperative Association Income Tax Return.

Used by Farmers' Cooperative Marketing and Purchasing Associations.

IT-IRC secs. 521, 522, 1381, 1382, 1383, 1385, 1388, 6012; Regs. secs. 1.521-1, 1.522-1, 1.1381-1, 2, 1.1382-1, 2, 3, 4, 5, 6, 7, 1.1383-1, 1.1385-1, 1.1388-1, 1.6012-2(f); Separate instructions

990–PF (1983)

Return of Private Foundation or Section 4947(a)(1) Trust Treated as a Private Foundation.

Used by private foundations and section 4947(a)(1) trusts. (An information return.)

IT-IRC sec. 6033; IRC Chapter 42, Regs. sec. 1.6033-2; Separate instructions

990–T (1983)

Exempt Organization Business Income Tax Return.

Used by exempt organization with unrelated business income (under section 511 of the IRC).

IT-IRC secs. 511 and 6012; Regs. secs. 1.6012-2(e), 1.6012-3(a)(5); Separate instructions

1040 (1983)

U.S. Individual Income Tax Return.

Used by citizens and residents of the United States to report income tax. Also see Form 1040A and Form 1040EZ.

IT-IRC secs. 6012 and 6017; Regs. secs. 1.142-1, 1.6012-1, and 1.6017-1; Pub. 17; Separate instructions

Sch. A (Form 1040) (1983)

Itemized Deductions.

Used to report itemized deductions (medical and dental expenses, taxes, contributions, interest, casualty and theft losses, and miscellaneous deductions).

IT-IRC secs. 163, 164, 165, 170, 211, 212, 213 and 222; Pub. 17; Separate instructions

Sch. B (Form 1040) (1983)

Interest and Dividend Income.

Used to list gross dividends (if in excess of $400), to exclude stock dividends from a reinvestment plan of a qualified public utility, to report any interest from an All-Savers Certificate, and to report other interest income (if in excess of $400) received. Also used to answer questions about Foreign Accounts and Foreign Trusts.

IT-IRC secs. 61, 116, 128, 305(e) and 6012; Pub. 17; Seperate instructions

Sch. C (Form 1040) (1983)

Profit or (Loss) from Business or Profession.

Used to compute profit (or loss) from business or profession.

IT-IRC sec. 6017; Regs. sec. 1.6017-1; Pubs. 17 and 334; Separate instructions

Sch. D (Form 1040) (1983)

Capital Gains and Losses.

Used to report details of gain (or loss) from sales and exchanges of capital assets and to compute post-1969 capital loss carryovers from 1983 to 1984.

IT-IRC secs. 1202-1223; Pubs. 17 and 334; Separate instructions

Sch. E (Form 1040) (1983)

Supplemental Income Schedule.

Used to report income from rents, royalties, partnerships, S corporations, estates, and trusts.

IT-IRC secs. 6012 and 6017; Regs. secs. 1.6012-1 and 1.6017-1; Pub. 17; Separate instructions

Sch. F (Form 1040) (1983)

Farm Income and Expenses.

Used to compute profit (or loss) from farming.

IT-IRC sec. 6012; Regs. sec. 1.61-4; Pub. 225; Seperate instructions

Sch. G (Form 1040) (1983)

Income Averaging.

Used to determine whether tax computed under the averaging provisions is the most advantageous method.

IT-IRC secs. 1301 and 1305

Sch. R&RP (Form 1040) (1983)

Credit for the Elderly.

Used to compute the credit for the elderly for individuals 65 or over and individuals under 65 having Public Retirement System Income.

IT-IRC sec. 37; Pub. 17; Separate instructions

Sch. SE (Form 1040) (1983)

Computation of Social Security Self-Employment Tax.

Used to compute self-employment tax.

IT-IRC secs. 1401 and 1402; Separate instructions

Sch. W (Form 1040) (1983)

Deduction for a Married Couple When Both Work.

Used to compute the deduction allowed to a married couple filing jointly when both have qualified earned income.

IT-IRC sec. 221; Pub. 17

1040A (1983)

U.S. Individual Income Tax Return.

Used by citizens and residents of the United States to report income tax.

IT-IRC sec. 6012; Regs. sec. 1.6012-1; Separate instructions

1040-ES (1984)

Estimated Tax for Individuals.

Used to make estimated tax payments as a means for paying currently any income tax (including self-employment tax) due in excess of the tax withheld from wages, salaries, and other payments for personal services. It is not required unless the total tax exceeds withholding (if any) and applicable tax credits by $400 or more.

IT-IRC sec. 6015; Regs. sec. 1.6015(d)-1

1040EZ (1983)

Income Tax Return for Single Filers with No Dependents.

Used by citizens and residents of the United States to report income tax. Also see Form 1040A.

IT-IRC sec. 6012; Regs. sec. 1.6012-1; Separate instructions

1040NR (1983)

U.S. Nonresident Alien Income Tax Return.

Used by all nonresident alien individuals who file a U.S. tax return, whether or not engaged in a trade or business within the United States. Also used as required for filing nonresident alien fiduciary (Estate and Trust) returns.

IT-IRC secs. 871 and 6012; Pub. 519; Separate instructions

1040X (Rev. 10-83)

Amended U.S. Individual Income Tax Return.

Used to claim refund of income taxes, pay additional income taxes, or designate dollar(s) to a Presidential Election Campaign fund.

IT-IRC secs. 6402, 6404, 6511, and 6096; Separate instructions

1041 (1983)

U.S. Fiduciary Income Tax Return (For Estates and Trusts).

Used by a fiduciary for domestic estate or domestic trust. (An annual return.)

IT-IRC sec. 6012; Regs. secs. 1.671-4, 1.6012-3(a); Separate instructions

Sch. D (Form 1041) (1983)

Capital Gains and Losses.

Used to report details of gain (or loss) from sales or exchanges of capital assets.

IT-IRC sec. 6012; Regs. sec. 1.6012-3; Separate instructions

Sch. K–1 (Form 1041) (1983)

Beneficiary's Share of Income, Deductions, Credits, etc.

Used to report each beneficiary's share of the income, deductions, credits, and items of tax preference from the estate or trust.

IT-IRC sec. 6012; Regs. sec. 1.6012-3(a)

Sch. J (Form 1041) (1983)

Trust Allocation of an Accumulation Distribution (IRC Section 665).

Used for domestic complex trusts.

IT-IRC secs. 665, 666, and 667

1065 (1983)

U.S. Partnership Return of Income.

Used by partnerships as an information return.

IT-IRC secs. 6031 and 6698; Regs. secs. 1.761-1(a), 1.6031-1; Separate instructions

Sch. D (Form 1065) (1983)

Capital Gains and Losses

Used to show partnership capital gains and losses that are not specially allocated.

IT-IRC secs. 1202-1223

Sch. K (Form 1065) (1983)

Partners' Share of Income, Credits, Deductions, etc.

Used to show partners' share of income, credits, deductions, etc. if more than 10 Schedules K-1 (Form 1065).

IT-IRC sec. 702

Sch. K-1 (Form 1065) (1983)

Partner's Share of Income, Credits, Deductions, etc.

Used to show partner's share of income, credits, deductions, etc. A four-part assembly—one copy is filed with Form 1065, one copy is for partnership records, and one copy is given to each partner. The last page is instructions for the partner.

IT-IRC sec. 702

1096 (1983)

Annual Summary and Transmittal of U.S. Information Returns.

Used for summarizing and transmitting reports on Forms 1099-ASC, 1099-B, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-OID, 1099-PATR, and 5498.

IT-IRC secs. 408(i), 6041, 6042, 6043, 6044, 6045, 6049, 6050A, 6050B, 6050E; Separate instructions

1099-B (1983)

Statement for Recipients of Proceeds from Broker or Barter Exchange Transactions.

Used to report proceeds from the sale or redemption of securities, commodities, futures contracts, or exchanges of goods or services by a barter exchange.

IT-IRC sec. 6045

1099-DIV (1983)

Statement for Recipients of Dividends and Distributions.

Used to report dividends and distributions (including distributions in liquidation).

IT-IRC secs. 6042 and 6043

1099-G (1983)

Statement for Recipients of Certain Government Payments.

Used by Federal, State, or local governments to report payments of unemployment compensation; State and local income tax refunds, offsets, or credits; discharges of indebtedness; taxable grants; or agriculture subsidy payments (including PIK).

IT-IRC secs. 6041, 6050B, and 6050E

1099-INT (1983)

Statement for Recipients of Interest Income.

Used to report interest income (including interest on bearer certificates of deposit).

IT-IRC secs. 6041 and 6049

1099-MISC (1983)

Statement for Recipients of Miscellaneous Income.

Used to report rents, royalties, prizes and awards, fishing boat proceeds, medical and health care payments by medical and health care insurers, nonemployee compensation, and direct sales of $5,000 or more.

IT-IRC secs. 6041, 6041A, and 6050A; Rev. Rul. 69-595, 1969-2, C.B. 242, and Rev. Rul. 70-608, 1970-2 C.B. 286

1099-OID (1983)

Statement for Recipients of Original Issue Discount.

Used to report original issue discount.

IT-IRC secs. 6049 and 1232

1099-PATR (1983)

Statement for Recipients (Patrons) of Taxable Distributions Received from Cooperatives.

Used to report patronage dividends.

IT-IRC sec. 6044

1099R (1983)

Statement for Recipients of Total Distributions from Profit-Sharing, Retirement Plans, and Individual Retirement Arrangements.

Used to report total distributions from profit sharing, retirement plans, and individual retirement arrangements.

IT-IRC secs. 6047, 402, 408

1116 (1983)

Computation of Foreign Tax Credit-Individual, Fiduciary, or Nonresident Alien Individual.

Used to figure and support the foreign tax credit claimed for the amount of any income, war profits, and excess profits taxes paid or accrued during the tax year to any foreign country or U.S. possession.

IT-IRC secs. 901 and 904; Pub. 514; Separate instructions

Sch. A (Form 1116) (1983)

Schedule of Foreign Taxable Income and Foreign Taxes Paid or Accrued.

Used as an attachment to Form 1116, Computation of Foreign Tax Credit—Individual, Fiduciary, or Nonresident Alien Individual, to figure and support the foreign tax credit claimed when income has been derived from, or taxes have been paid to, more than one foreign country or U.S. possession.

IT-IRC secs. 901 and 904; Pub. 514; Separate instructions

1120 (1983)

U.S. Corporation Income Tax Return.

Used by a corporation to report income tax.

IT-IRC sec. 6012; Regs. secs. 1.1502-75(b), 1.831-3(c), 1.6012-2; Separate instructions

Sch. D (Form 1120) (1983)

Capital Gains and Losses.

Used by a taxpayer who files either Forms 1120, 1120-DISC, 1120F, 1120-H, 1120L, 1120M, 1120-POL, 990-C, or certain Forms 990-T, to report details of gain (or loss) from sales or exchanges of capital assets, and to figure the alternative tax.

IT-IRC secs. 1201 and 1231

Sch. PH (Form 1120) (1983)

Computation of U.S. Personal Holding Company Tax.

Used to compute personal holding company tax; filed with the income tax return of every personal holding company.

IT-IRC secs. 541, 6012, 6501(f)

1120-DISC (1983)

Domestic International Sales Corporation Return.

Used for a tax year relating to a DISC.

IT-IRC secs. 6011(c), 6072(b); Separate instructions

Sch. K (Form 1120-DISC) (1983)

Shareholder's Statement of DISC Distribution.

Used to report deemed and actual distributions from a DISC to shareholders.

IT-IRC sec. 6011(c)

Sch. N (Form 1120-DISC) (1983)

Export Gross Receipts of the DISC and Related U.S. Persons.

Used to report geographic source of gross receipts of the DISC and certain related persons.

IT-IRC sec. 6011(c); Separate instructions

1120F (1983)

U.S. Income Tax Return of a Foreign Corporation.

Used by foreign corporations to report income tax.

IT-IRC secs. 881, 882, and 6012; Separate instructions

1120S (1983)

U.S. Income Tax Return for an S Corporation.

Used by S corporations to report taxes under Subchapter S of the IRC and as an information return.

IT-IRC sec. 6037, Subchapter S; Regs. sec. 1.6037-1; Seperate instructions

Sch. D (Form 1120S) (1983)

Capital Gains and Losses.

Used by S corporations to report details of gains (and losses) from sales or exchanges of capital assets and to figure the tax imposed on certain capital gains.

IT-IRC secs. 1201, 1231, and IRC Subchapter S

Sch. K–1 (Form 1120S) (1983)

Shareholder's Share of Income, Credits, Deductions, etc.

Used to show shareholder's share of income, credits, deductions, etc. A four-part assembly: One copy is filed with Form 1120S, one copy is for corporate records, and one copy is given to each shareholder. The last sheet is instructions for the shareholder.

IT-IRC sec. 6037; Regs. sec. 1.6037-1

1120–W (Worksheet) (1984)

Corporation Estimated Tax.

Used as a worksheet by corporations to compute estimated tax liability; not required to be filed. Corporations should keep it for their records.

IT-IRC sec. 6154

1120X (Rev. 10–83)

Amended U.S. Corporation Income Tax Return.

Used by corporations to amend a previously filed Form 1120.

IT-Regs. sec. 301:6402-3

1139 (Rev. 11–83)

Corporation Application for Tentative Refund.

Used by corporations which have certain carrybacks and desire a quick refund of taxes.

IT-IRC sec. 6411

1310 (Rev. 8–81)

Statement of Person Claiming Refund Due a Deceased Taxpayer.

Used by a claimant to secure payment of refund on behalf of a deceased taxpayer.

IT-IRC sec. 6402; Regs. sec. 301.6402-2(e)

2106 (1983)

Employee Business Expenses.

For optional use to support deductions from income tax for travel, transportation, outside salesperson and educational expenses (except moving expenses).

IT-IRC secs. 162 and 274

2119 (1983)

Sale or Exchange of Principal Residence.

For use by individuals who sold their principal residence. Also used by those individuals 55 or older who elect to exclude gain on the sale of their principal residence.

IT-IRC secs. 121 and 1034; Pub. 17

2120 (Rev. 9–81)

Multiple Support Declaration.

Used as a statement disclaiming as an income tax exemption an individual to whose support the taxpayer and others have contributed.

IT-IRC sec. 152(c); Regs. sec. 1.152-3(c); Pub. 17

2210 (1983)

Underpayment of Estimated Tax by Individuals.

Used by individuals to see if they paid enough estimated tax. It is also used to see if any of the exceptions to the penalty for underpayment of estimated tax are met and, if not, to figure the penalty.

IT-IRC sec. 6654; Regs. sec. 1.6654-1; Pub. 505

2220 (1983)

Underpayment of Estimated Tax by Corporations.

Used by a corporation to determine whether it paid enough estimated tax, whether it is subject to the penalty for underpayment of estimated tax, and how much penalty it may owe for any underpayment.

(If additional tax is due, a computation schedule is provided.)

IT-IRC sec. 6655; Regs. sec. 1.6655-1(b)

2350 (1983)

Application for Extension of Time to File U.S. Income Tax Return.

Used by U.S. citizens and U.S. resident aliens abroad who expect to qualify for special tax treatment to obtain an extension of time for filing an income tax return.

IT-IRC secs. 911and 6081; Pub. 54

2440 (1983)

Disability Income Exclusion.

Used to compute amount of disability income exclusion

IT-IRC sec. 105; Instructions for Form 1040; Pubs. 17 and 522

2441 (1983)

Credit for Child and Dependent Care Expenses.

Used to support credit for child and dependent care expenses. (To be attached to Form 1040.)

IT-IRC sec. 44A; Regs. sec. 1.44A-1; Inst. for Form 1040; Pubs. 17 and 503

2555 (1983)

Foreign Earned Income.

Used by U.S. citizens and U.S. resident aliens who qualify for the foreign earned income exclusion or the housing exclusion or deduction.

IT-IRC sec. 911; Pub. 54; Separate instructions

2688 (1983)

Application for Extension of Time to File U.S. Individual Income Tax Return.

Used to apply for an additional extension of time to file Form 1040 or 1040A.

IT-IRC sec. 6081; Regs. sec. 1.6081-1(b)

2758 (Rev. 10–83)

Application for Extension of Time to File U.S. Partnership, Fiduciary, and Certain Exempt Organization Returns.

Used to apply for an extension of time to file Form 1065, Form 1041, and certain exempt organization returns.

IT-IRC sec. 6081; Regs. sec. 1.6081-1(b)

2848 (Rev. 10–83)

Power of Attorney and Declaration of Representative.

Used as an authorization for one person to act for another in any tax matter (except alcohol and tobacco taxes and firearms activities).

IT-Title 26, CFR, Part 601; Seperate instructions

3468 (1983)

Computation of Investment Credit.

Used by individuals, estates, trusts, and corporations claiming a regular or business energy investment credit.

IT-IRC secs. 38, 46, 47, and 48; Separate instructions

3903 (1983)

Moving Expense Adjustment.

For optional use to support deductions from income for expenses of travel, transportation (including meals and lodging), and certain expenses of selling an old residence and buying a new residence for employees or self-employed individuals moving to a new job location in the U.S. or its possessions.

IT-IRC sec. 217; Regs. sec. 1.217; Pub. 521

4136 (1983)

Computation of Credit for Federal Tax on Gasoline, Special Fuels, and Lubricating Oil.

Used by individuals, estates, trusts, or corporations, including S corporations and domestic international sales corporations, to claim credit for Federal excise tax on the number of gallons of gasoline, special fuels, and lubricating oil used in business (including qualified taxicabs).

Ex-IRC secs. 39, 4041, 4081, 6420, 6421, 6424, and 6427

4137 (1983)

Computation of Social Security Tax on Unreported Tip Income.

Filed by an employee who received tips subject to social security tax but failed to report them to his or her employer.

Emp.-IRC sec. 3102; Regs. Secs. 31.3102-3(d), 31.6011(a)-1(d)

4255 (Rev. 11–82)

Recapture of Investment Credit.

Used by individuals, estates, trusts, or corporations to recapture the regular or energy investment credit taken on property disposed of before the end of the useful life or recovery period used in computing the credit. The tax must be increased if the credit allowed is more than the credit allowable at the time of disposition.

IT-IRC sec. 47; Regs. sec. 1.47-1

4466 (1983)

Corporation Application for Quick Refund of Overpayment of Estimated Tax.

Used to apply for a "quick" refund of overpaid estimated tax. (Must be filed before the regular tax return is filed.)

IT-IRC sec. 6425; Regs. sec. 1.6425-1(b)

4562 (Rev. 9–83)

Depreciation and Amortization.

For use by individuals, estate and trusts, partnerships, and corporations claiming depreciation or amortization.

IT-IRC secs. 58 (i),167, 168, 169, 174, 177, 179, 185, 188, 189, 191 (as before repeal by Public Law 97-34), 194, 195, 248, and 709

4626 (1983)

Computation of Minimum Tax—Corporations.

Used generally by corporations to compute minimum tax when tax preferences are more than $10,000.

IT-IRC secs. 56, 57, and 58

4684 (1983)

Casualties and Thefts.

For use by all taxpayers for reporting gains and losses from casualties and thefts.

IT-IRC secs. 165 and 1231; Separate instructions

4782 (Rev. 8–83)

Employee Moving Expense Information.

Used by employers to show employees the amount of any reimbursement or payment made to an employee, a third party for the employee's benefit, or the value of services furnished in-kind, for moving expenses during the calendar year.

IT-IRC secs. 82 and 217; Regs. sec 31.6051-1(e)

4797 (1983)

Supplemental Schedule of Gains and Losses.

Used to report details of gain (or loss) from sales, exchanges, or involuntary conversions (other than casualties and thefts) of noncapital assets and involuntary conversions of capital assets (other than casualties and thefts) held for more than one year.

IT-IRC secs. 1231, 1245, 1250, 1251, 1252, 1254 and 1255; Separate instructions

4798 (1983)

Carryover of Pre-1970 Capital Losses.

Used by an individual to figure the capital loss limitation if pre-1970 losses are involved, and any capital loss carryover from the current tax year to the following tax year.

IT-IRC secs. 1211 and 1212

4835 (1983)

Farm Rental Income and Expenses.

Used by landowner (or sublessor) to report farm rental income based on crops or livestock produced by the tenant where the landowner (or sublessor) does not materially participate in the operation or management of the farm.

IT-IRC sec. 61

4868 (1983)

Application for Automatic Extension of Time to File U.S. Individual Income Tax Return.

Used to apply for an automatic 4-month extension of time to file Form 1040 or 1040A.

IT-IRC sec. 6081; Regs. sec. 1.6081-4

4952 (1983)

Investment Interest Expense Deduction.

Used by an individual, estate, or trust to compute the deduction limitation for interest expense on funds borrowed to purchase or carry property held for investment.

IT-IRC sec. 163(d)

4970 (1983)

Tax on Accumulation Distribution of Trusts.

For use by a beneficiary of a domestic or foreign trust to compute the tax attributable to an accumulation distribution.

IT-IRC sec. 667

4972 (1983)

Special 10-Year Averaging Method.

Used to determine the income tax on the ordinary income portion of lump-sum distributions.

IT-IRC sec. 402(e); Separate instructions

5329 (1983)

Return for Individual Retirement Arrangement Taxes.

Used to report the various individual retirement arrangement taxes under sections 408(f), 409(c), 4973, and 4974.

5330 (Rev. 12–83)

Return of Initial Excise Taxes Related to Pension and Profit-Sharing Plans.

Used to report excise taxes imposed by IRC sections 4971, 4973(a)(2) and 4975.

5498 (1983)

Individual Retirement Arrangement Information.

Used to report calendar year contributions to IRAs or SEPs.

IT-IRC sec. 408(i)

5500 (1983)

Annual Return/Report of Employee Benefit Plan.

Used to report on deferred compensation plans and welfare plans that have at least 100 participants.

IT-IRC sec. 6058(a); ERISA section 103

Sch. A (Form 5500) (1983)

Insurance Information.

Used as an attachment to Forms 5500, 5500-C, or 5500-K to report information about insurance contracts that are part of a qualified deferred compensation plan.

IT-ERISA section 103(e)

Sch. B (Form 5500) (1983)

Actuarial Information.

Used to report actuarial information with respect to a defined benefit plan. It is attached to Form 5500, 5500-C, or 5500-K.

IT-IRC sec. 6059; ERISA sec. 103(a)

Sch. P (Form 5500) (1983)

Annual Return of Fiduciary of Employee Benefit Trust.

Used as an attachment to Forms 5500, 5500-C, 5500-G, 5500-K and 5500-R to satisfy reporting requirements under IRC section 6033(a) and start statute of limitations under IRC section 6501(a).

IT-IRC secs. 6033(a) and 6501(a)

Sch. SSA (Form 5500) (1983)

Registration Statement Identifying Separated Participants with Deferred Vested Benefits.

Used as an attachment to Forms 5500, 5500-C, or 5500-K to list the employees who separated from employment and have a deferred vested benefit in the employer's plan of deferred compensation.

IT-IRC sec. 6057

5500–C (1983)

Return/Report of Employee Benefit Plan.

Used to report on deferred compensation plans and welfare plans that have fewer than 100 participants, none of whom is an owner-employee.

IT-IRC sec. 6058(a); ERISA sec. 103

5500–K (1983)

Return/Report of Employee Pension Benefit Plan for Sole Proprietorships and Partnerships.

Used to report on H.R. 10 (Keogh) plans that have fewer than 100 participants and at least one owner-employee participant.

IT-IRC sec. 6058(a); ERISA sec. 103

5500–R (1983)

Registration Statement of Employee Benefit Plan.

Used to report on deferred compensation plans and welfare plans that have fewer than 100 participants. This form is filed for plan years when Form 5500-C or 5500-K is not required to be filed.

IT-IRC sec. 6058(a); ERISA sec. 103

5544 (1983)

Multiple Recipient Special 10-Year Averaging Method.

Used to determine income tax on the ordinary income portion of lump-sum distributions received by a multiple recipient.

IT-IRC sec. 402(e); Separate instructions

5558 (Rev. 10–82)

Application for Extension of Time to File Certain Employee Plan Returns.

Used to request an extension of time to file Forms 5500, 5500-C, 5500-K, 5500-R and 5330.

IRC sec. 6081(a)

5695 (1983)

Residential Energy Credit.

Used by individual taxpayers to claim a credit against their tax for qualified energy-saving property.

IT-IRC sec. 44C

5884 (1983)

Jobs Credit (and WIN credit carryover).

Used by individuals, estates, trusts, and corporations claiming a jobs credit or WIN credit carryover, and any S corporation, partnership, estate, or trust which apportions the credits among its shareholders, partners, or beneficiaries.

IT-IRC secs. 44B, 51, 52, and 53

6198 (1983)

Computation of Deductible Loss from an Activity Described in Section 465(c).

Used by taxpayers to determine the overall profit (loss) from an at-risk activity, the amount at risk, and the deductible loss.

IT-IRC sec. 465; Separate instructions

6251 (1983)

Alternative Minimum Tax Computation.

Used by individuals, estates, and trusts to report tax preference items and to compute their alternative minimum tax liability.

IT-IRC secs. 55 and 57

6252 (1983)

Computation of Installment Sale Income.

Used by taxpayers other than dealers, who sell real or personal property, and receive any payment from the sale in a tax year after the year of sale.

IT-IRC sec. 453; Pub. 537

6765 (1983)

Credit for Increasing Research Activities (or for claiming the orphan drug credit).

Used by individuals, estates, trusts, and corporations to claim a credit for increasing research activities for a trade or business. Also used to claim the orphan drug credit.

IT-IRC secs. 44F and 44H; Pub. 906

6781 (1983)

Gains and Losses from Regulated Futures Contracts and Straddles.

Used by all taxpayers that held regulated futures contracts or straddles during the tax year.

IT-IRC secs. 1092 and 1256

7004 (Rev. 10–83)

Application for Automatic Extension of Time to File Corporation Income Tax Return.

Used by corporations and certain exempt organizations to request an automatic extension of 6 months to file its income tax return.

IT-IRC sec. 6081(b); Regs. sec. 1.6081-3

8027 (1983)

Employer's Annual Information Return of Tip Income and Allocated Tips.

Used by large food or beverage establishments to report certain receipts from food or beverage operations, tips reported by employees, and in certain cases, tips allocated to employees.

IT-IRC sec. 6053(c)

Treasury Department Form 90–22.1 (Rev. 9–83)

Report of Foreign Bank and Financial Accounts.

Filed by any individual, trust, partnership, or corporation that has a financial interest in, or signature authority or other authority over, bank, securities, or other financial accounts in a foreign country, that exceeded $5,000 in aggregate value at any time during the calendar year.

P.L. 91-508; Treasury Regs. (31 CFR 103)

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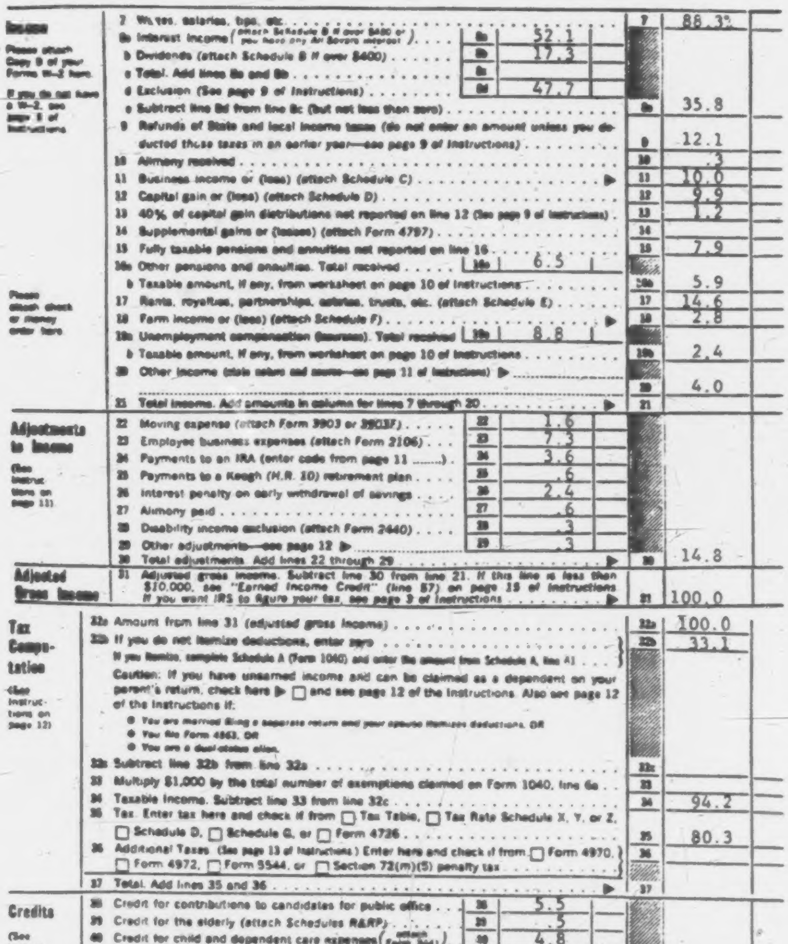
ATTACHMENT C: PERCENTAGE OF INDIVIDUAL TAXPAYERS REPORTING SELECTED ITEMS ON TAX RETURNS, 1981



Income • Please attach Copy B of your Forms W-2 here. If you do not have a W-2, see page 5 of Instructions	7	Wages, salaries, tips, etc.			7	88.3%
	8a	Interest income (attach Schedule B if over $400 or you have any All Savers interest)	8a	52.1		
	b	Dividends (attach Schedule B if over $400)	8b	17.3		
	c	Total. Add lines 8a and 8b	8c			
	d	Exclusion (See page 9 of Instructions)	8d	47.7		
	e	Subtract line 8d from line 8c (but not less than zero)			8e	35.8
	9	Refunds of State and local income taxes (do not enter an amount unless you deducted those taxes in an earlier year—see page 9 of Instructions)			9	12.1
	10	Alimony received			10	.3
	11	Business income or (loss) (attach Schedule C) ▶			11	10.0
	12	Capital gain or (loss) (attach Schedule D)			12	9.9
	13	40% of capital gain distributions not reported on line 12 (See page 9 of Instructions)			13	1.2
	14	Supplemental gains or (losses) (attach Form 4797)			14	
	15	Fully taxable pensions and annuities not reported on line 16			15	7.9
	16a	Other pensions and annuities. Total received	16a	6.5		
	b	Taxable amount, if any, from worksheet on page 10 of Instructions			16b	5.9
Please attach check or money order here	17	Rents, royalties, partnerships, estates, trusts, etc. (attach Schedule E)			17	14.6
	18	Farm income or (loss) (attach Schedule F) ▶			18	2.8
	19a	Unemployment compensation (insurance). Total received	19a	8.8		
	b	Taxable amount, if any, from worksheet on page 10 of Instructions			19b	2.4
	20	Other income (state nature and source—see page 11 of Instructions) ▶			20	4.0
	21	Total income. Add amounts in column for lines 7 through 20 ▶			21	
Adjustments to Income (See Instructions on page 11)	22	Moving expense (attach Form 3903 or 3903F)	22	1.6		
	23	Employee business expenses (attach Form 2106)	23	7.3		
	24	Payments to an IRA (enter code from page 11 ....)	24	3.6		
	25	Payments to a Keogh (H.R. 10) retirement plan	25	.6		
	26	Interest penalty on early withdrawal of savings	26	2.4		
	27	Alimony paid	27	.6		
	28	Disability income exclusion (attach Form 2440)	28	.3		
	29	Other adjustments—see page 12 ▶	29	.3		
	30	Total adjustments. Add lines 22 through 29 ▶			30	14.8
Adjusted Gross Income	31	Adjusted gross income. Subtract line 30 from line 21. If this line is less than $10,000, see "Earned Income Credit" (line 57) on page 15 of Instructions. If you want IRS to figure your tax, see page 3 of Instructions ▶			31	100.0
Tax Computation (See Instructions on page 12)	32a	Amount from line 31 (adjusted gross income)			32a	100.0
	32b	If you do not itemize deductions, enter zero If you itemize, complete Schedule A (Form 1040) and enter the amount from Schedule A, line 41 Caution: If you have unearned income and can be claimed as a dependent on your parent's return, check here ▶ ☐ and see page 12 of the Instructions. Also see page 12 of the Instructions if: ● You are married filing a separate return and your spouse itemizes deductions, OR ● You file Form 4563, OR ● You are a dual-status alien.			32b	33.1
	32c	Subtract line 32b from line 32a			32c	
	33	Multiply $1,000 by the total number of exemptions claimed on Form 1040, line 6e			33	
	34	Taxable Income. Subtract line 33 from line 32c			34	94.2
	35	Tax. Enter tax here and check if from ☐ Tax Table, ☐ Tax Rate Schedule X, Y, or Z, ☐ Schedule D, ☐ Schedule G, or ☐ Form 4726			35	80.3
	36	Additional Taxes. (See page 13 of Instructions.) Enter here and check if from ☐ Form 4970, ☐ Form 4972, ☐ Form 5544, or ☐ Section 72(m)(5) penalty tax			36	
	37	Total. Add lines 35 and 36 ▶			37	
Credits (See Instructions on page 13)	38	Credit for contributions to candidates for public office	38	5.5		
	39	Credit for the elderly (attach Schedules R&RP)	39	.5		
	40	Credit for child and dependent care expenses (attach Form 2441)	40	4.8		
	41	Investment credit (attach Form 3468)	41	4.7		
	42	Foreign tax credit (attach Form 1116)	42	.4		
	43	Work incentive (WIN) credit (attach Form 4874)	43	.01		
	44	Jobs credit (attach Form 5884)	44	.1		
	45	Residential energy credit (attach Form 5695)	45	4.1		
	46	Total credits. Add lines 38 through 45			46	
	47	Balance. Subtract line 46 from line 37 and enter difference (but not less than zero) ▶			47	80.3
Other Taxes (Including Advance EIC Payments)	48	Self-employment tax (attach Schedule SE)			48	8.1
	49a	Minimum tax. Attach Form 4625 and check here ▶ ☐			49a	.1
	49b	Alternative minimum tax. Attach Form 6251 and check here ▶ ☐			49b	.7
	50	Tax from recomputing prior-year investment credit (attach Form 4255)			50	.1
	51a	Social security (FICA) tax on tip income not reported to employer (attach Form 4137)			51a	
	51b	Uncollected employee FICA and RRTA tax on tips (from Form W-2)			51b	
	52	Tax on an IRA (attach Form 5329)			52	.1
	53	Advance earned income credit (EIC) payments received (from Form W-2)			53	.8
06	54	Total tax. Add lines 47 through 53 ▶			54	8.7
Payments Attach Forms W-2, W-2G, and W-2P to front	55	Total Federal income tax withheld	55	86.1		
	56	1981 estimated tax payments and amount applied from 1980 return	56	10.0		
	57	Earned income credit. If line 32a is under $10,000, see page 15 of Instructions	57	5.0		
	58	Amount paid with Form 4868	58			
	59	Excess FICA and RRTA tax withheld (two or more employers)	59	1.1		
	60	Credit for Federal tax on special fuels and oils (attach Form 4136 or 4136-T)	60	1.1		
	61	Regulated Investment Company credit (attach Form 2439)	61	.1		
	62	Total. Add lines 55 through 61 ▶			62	
Refund or Balance Due	63	If line 62 is larger than line 54, enter amount OVERPAID ▶			63	73.4
	64	Amount of line 63 to be REFUNDED TO YOU ▶			64	71.6
	65	Amount of line 63 to be applied to your 1982 estimated tax ▶	65	2.6		
	66	If line 54 is larger than line 62, enter BALANCE DUE. Attach check or money order for full amount payable to "Internal Revenue Service." Write your social security number and "1981 Form 1040" on it. ▶ (Check ▶ ☐ if Form 2210 (2210F) is attached. See page 16 of Instructions.) ▶ $			66	24.17

Individual Income Tax Returns, 1982 Taxpayer Usage Study

Table 9.--All Returns: Percentage Distribution of Selected Forms and Schedules, Classified by Size of Adjusted Gross Income, Tax Year 1982

Schedule or Form	Type of attachment	Total	Percentage of returns by size of adjusted gross income						
			Under $5,000	$5,000 under $10,000	$10,000 under $15,000	$15,000 under $20,000	$20,000 under $30,000	$30,000 under $50,000	$50,000 and over
		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	All Form 1040 returns filed..................	54,687	4,445	6,836	6,794	6,850	12,561	13,503	3,699
	Percent..............	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
A	Itemized Deductions...........	57.4	13.6	23.4	37.3	47.0	66.1	86.0	95.4
B	Interest and Dividend Income..	46.6	43.7	47.5	45.7	40.7	39.4	49.0	77.2
C	Profit or (Loss) From Business or Profession................	16.4	25.3	20.8	15.1	13.8	14.9	13.8	19.8
D	Capital Gains and Losses......	12.9	9.8	8.2	9.1	9.4	11.2	15.0	36.1
E	Supplemental Income Schedule..	18.1	17.4	16.5	13.0	14.6	16.4	19.0	40.3
F	Farm Income and Expenses......	4.3	9.2	3.9	3.7	3.5	3.2	3.4	4.9
G	Income Averaging..............	9.2	0.6	0.6	3.5	5.1	9.4	15.5	29.7
R RP	Credit for the Elderly........	1.1	-	2.7	1.4	1.0	0.6	0.9	1.1
SE	Computation of Social Security Self-Employment Tax..........	15.4	26.3	19.7	14.3	15.0	12.7	12.2	18.6
W	Deduction for a Married Couple When Both Work...............	30.8	1.6	8.0	13.0	22.2	36.3	57.1	41.8
1116	Computation of Foreign Tax Credit.......................	0.4	-	0.2	-	0.2	0.4	0.6	1.9
2106	Employee Business Expenses....	10.2	1.9	4.5	8.5	9.9	12.5	12.9	16.0
2119	Sale or Exchange of Principal Residence....................	1.3	0.6	1.0	1.0	1.4	1.3	1.3	3.1
2210/ 2210F	Underpayment of Estimated Income Tax...................	6.2	4.1	7.8	8.5	5.8	4.0	4.7	14.8
2440	Disability Income Exclusion...	0.5	1.9	1.0	0.4	0.6	0.1	-	0.4
2441	Credit for Child and Dependent Care Expenses...............	8.5	1.3	4.9	8.7	9.6	10.5	10.9	4.9
3468	Computation of Investment Credit.......................	6.4	5.4	4.5	6.0	7.2	4.4	6.1	17.9
3903	Moving Expense Adjustment.....	2.1	0.9	2.1	3.3	2.7	2.0	1.7	1.5
4136	Computation of Credit for Federal Tax on Gasoline, Special Fuels, and Lubricating Oil..............	1.3	3.2	1.2	1.7	1.4	0.8	0.9	1.1
4255	Recapture of Investment Credit	0.8	0.6	0.2	1.0	1.0	0.7	0.6	1.9
4562	Depreciation..................	14.2	18.7	13.6	11.4	15.0	12.8	13.1	23.2
4684	Casualties and Thefts.........	2.5	0.6	0.8	0.4	1.9	2.2	4.5	6.8
4797	Supplemental Schedule of Gains and Losses..................	2.2	4.4	1.0	1.0	3.5	1.7	2.1	3.1
4868	Application for Automatic Extension of Time to File	0.3	0.3	-	0.2	-	0.3	0.3	1.5
5329	Return for Individual Retirement Arrangement Taxes.......	0.2	-	0.2	-	0.2	-	0.3	0.4
5695	Residential Energy Credit.....	5.2	0.6	2.6	3.9	3.7	6.4	7.6	7.2
5884	Jobs Credit...................	0.1	0.6	-	0.2	0.2	-	-	0.4
6249/ 6249A	Computation of Overpaid Windfall Profit Tax..............	0.3	-	0.2	0.2	0.4	0.3	0.1	1.1
6251	Alternative Minimum Tax Computation.......................	0.6	-	-	0.2	0.2	0.1	1.1	4.2
6252	Computation of Installment Sale Income..................	1.3	-	0.8	0.6	0.8	1.0	2.1	3.4

ATTACHMENT D

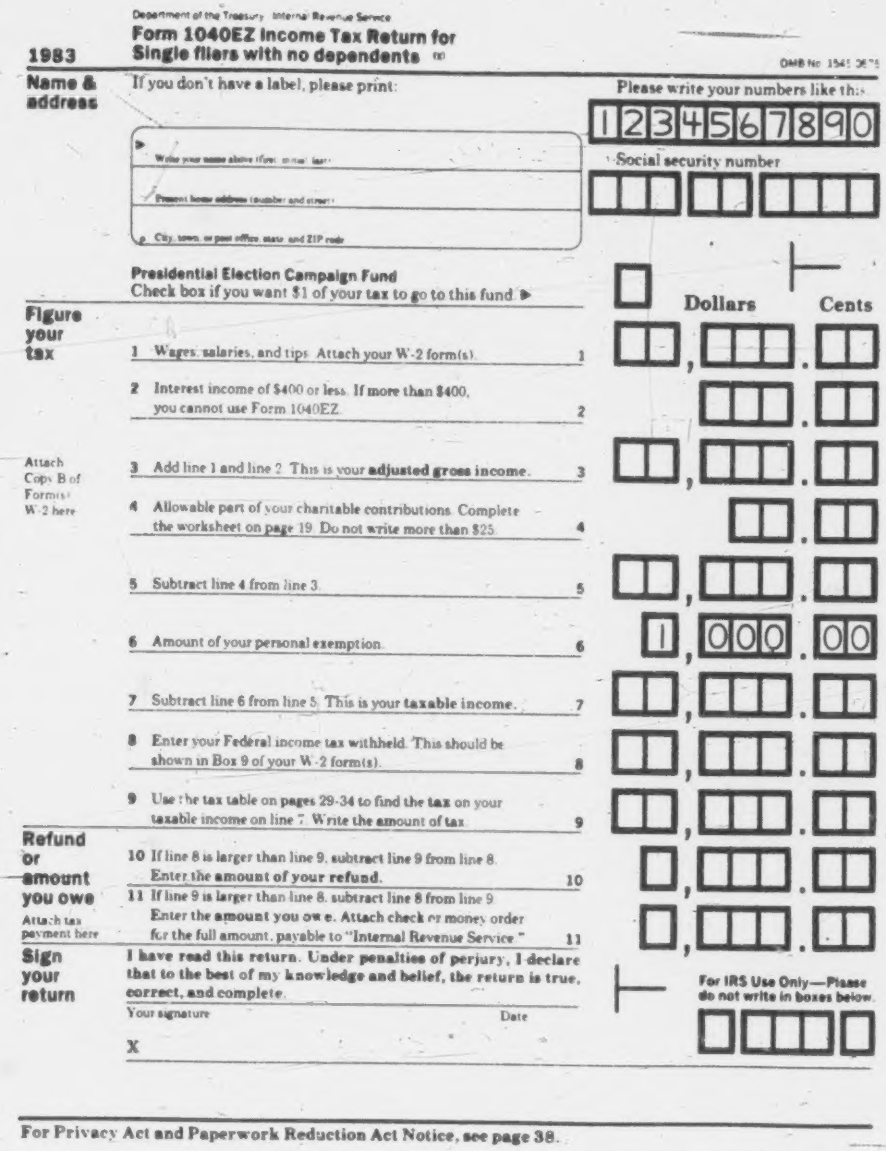
Second, be sure you use the tax form that is right for you

There are three tax forms for individuals—short Form 1040EZ for certain single taxpayers, Form 1040A, and Form 1040. All taxpayers can use Form 1040 if they want to, but you will probably save time if you are able to use one of the shorter forms instead.

Form 1040EZ, Form 1040A, or Form 1040?

The following chart shows the kinds of filing statuses, exemptions, income, deductions, taxes, and credits that can be shown on Forms 1040EZ, 1040A, and 1040. Use it to help determine which form to use.

Form 1040EZ	**Form 1040A**	**Form 1040**	
Filing status: Single only	**Filing status:** Single, married filing joint, married filing separate, or head of household	**Filing status:** Single, married filing joint, married filing separate, head of household, or qualifying widow(er) with dependent child	
Number of exemptions: Only one personal exemption for yourself	**Number of exemptions:** All exemptions that you are entitled to claim	**Number of exemptions:** All exemptions that you are entitled to claim	
Only taxable income of less than $50,000	**Only taxable income of less than $50,000**	**All amounts of taxable income**	
Only income from: Wages, salaries, tips Interest (other than All-Savers interest) of $400 or less	**Only income from:** Wages, salaries, tips Interest (other than All-Savers interest) Dividends Unemployment compensation	**All sources of income:** Wages, salaries, tips Interest and dividends Unemployment compensation Self-employment (including farming) (Schedules C or F) Rents and royalties (Schedule E)	Pensions and annuities State and local income tax refunds (if taxable) Capital gains (Schedule D) Gain from the sale of your home (Form 2119) Alimony received All other sources
No itemized deductions You may deduct a part of some amounts you gave to charitable organizations	**No itemized deductions** You may deduct a part of some amounts you gave to charitable organizations	**All itemized deductions** (Use Schedule A) State and local income taxes Real estate taxes Sales taxes Interest expenses	Charitable contributions Medical and dental expenses Casualty and theft losses Miscellaneous deductions
No adjustments to income	**Adjustments to income for:** The deduction for a married couple when both work (Schedule 1) The deduction for payments to an IRA	**All adjustments to income:** Alimony paid Penalty for early withdrawal of savings Deduction for payments to an IRA or Keogh plan Moving expenses (Form 3903 or Form 3903F)	Employee business expenses (Form 2106) Disability income exclusion (Form 2440) Deduction for a married couple when both work (Schedule W) Other adjustments
No other taxes	**Other taxes:** Advance EIC payments	**Other taxes:** Advance EIC payments Self-employment tax (Schedule SE) Tax on an IRA (Form 5329) Alternative minimum tax (Form 6251)	Social security tax on tips not reported to your employer (Form 4137) Uncollected social security tax on tips shown on your Form W-2 All other income taxes
No tax credits	**Only tax credits for:** Partial political contributions credit Credit for child and dependent care expenses (Schedule 1) Earned income credit	**All tax credits:** Partial political contributions credit Earned income credit Credit for child and dependent care expenses (Form 2441) Investment credit (Form 3468) Jobs credit (Form 5884)	Foreign tax credit (Form 1116) Residential energy credit (Form 5695) Credit for the elderly (Schedules R & RP) All other credits



Department of the Treasury Internal Revenue Service

1983 **Form 1040EZ Income Tax Return for Single filers with no dependents**

OMB No. 1545-0675

Name & address

If you don't have a label, please print:

Please write your numbers like this:

1 2 3 4 5 6 7 8 9 0

Write your name above (first, initial, last)

Present home address (number and street)

City, town, or post office, state, and ZIP code

Social security number

☐☐☐ ☐☐ ☐☐☐☐

Presidential Election Campaign Fund
Check box if you want $1 of your tax to go to this fund. ▶ ☐

Figure your tax

Attach Copy B of Form(s) W-2 here

			Dollars	Cents
1	Wages, salaries, and tips. Attach your W-2 form(s).	1	☐☐,☐☐☐	☐☐
2	Interest income of $400 or less. If more than $400, you cannot use Form 1040EZ.	2	☐☐☐	☐☐
3	Add line 1 and line 2. This is your **adjusted gross income.**	3	☐☐,☐☐☐	☐☐
4	Allowable part of your charitable contributions. Complete the worksheet on page 19. Do not write more than $25.	4	☐☐	☐☐
5	Subtract line 4 from line 3.	5	☐☐,☐☐☐	☐☐
6	Amount of your personal exemption.	6	1,000	00
7	Subtract line 6 from line 5. This is your **taxable income.**	7	☐☐,☐☐☐	☐☐
8	Enter your Federal income tax withheld. This should be shown in Box 9 of your W-2 form(s).	8	☐☐,☐☐☐	☐☐
9	Use the tax table on pages 29-34 to find the **tax** on your taxable income on line 7. Write the amount of tax.	9	☐☐,☐☐☐	☐☐

Refund or amount you owe

Attach tax payment here

10	If line 8 is larger than line 9, subtract line 9 from line 8. Enter the **amount of your refund.**	10	☐,☐☐☐	☐☐
11	If line 9 is larger than line 8, subtract line 8 from line 9. Enter the **amount you owe.** Attach check or money order for the full amount, payable to "Internal Revenue Service."	11	☐,☐☐☐	☐☐

Sign your return

I have read this return. Under penalties of perjury, I declare that to the best of my knowledge and belief, the return is true, correct, and complete.

Your signature Date

X

For IRS Use Only—Please do not write in boxes below.

☐☐☐☐ ☐

For Privacy Act and Paperwork Reduction Act Notice, see page 38.

Department of the Treasury—Internal Revenue Service

1983 **Form 1040A US Individual Income Tax Return** OMB No.

Step 1
Name and address

Use the IRS mailing label. If you don't have a label, print or type.

Your first name and initial (if joint return, also give spouse's name and initial) Last name Your social security no.

Present home address (Number and street) Spouse's social security no.

City, town or post office, State, and ZIP code

Presidential Election Campaign Fund

Do you want $1 to go to this fund? ☐ Yes ☐ No

If joint return, does your spouse want $1 to go to this fund? ☐ Yes ☐ No

Step 2
Filing status
(Check only one)

1 ☐ Single (See if you can use Form 1040EZ.)

2 ☐ Married filing joint return (even if only one had income)

3 ☐ Married filing separate return. Enter spouse's social security number above and spouse's full name here ______

4 ☐ Head of household (with qualifying person). If the qualifying person is your unmarried child but not your dependent, write this child's name here ______

Exemptions

Always check the exemption box labeled Yourself. Check other boxes if they apply.

5a ☐ Yourself ☐ 65 or over ☐ Blind

b ☐ Spouse ☐ 65 or over ☐ Blind

Write number of boxes checked on 5a and b ______

c First names of your dependent children who lived with you ______

Write number of children listed on 5c ______

Attach Copy B of Form(s) W-2 here

d Other dependents

1. Name	2. Relationship	3. Number of months lived in your home	4. Did dependent have income of $1,000 or more?	5. Did you provide more than one-half of dependent's support?

Write number of other dependents listed on 5d ______

e Total number of exemptions claimed

Add numbers entered on lines above ______

Step 3
Total income

Attach check or money order here

6 Wages, salaries, tips, etc. (Attach Form(s) W-2.) 6

7 Interest income (If line 7 is over $400, also complete Schedule 1, Part I.) 7

8a Dividends (If line 8a is over $400, also complete Schedule 1, Part II.) 8a

b Exclusion. See the instructions on page 14 8b

c Subtract line 8b from line 8a. Write the result 8c

9a Unemployment compensation (insurance), from Form(s) 1099-G 9a

b Taxable amount, if any, from the worksheet on page 15 of the instructions 9b

10 Add lines 6, 7, 8c, and 9b. Write the total. This is your total income. 10

Step 4
Adjusted gross income

11a IRA deduction, from the worksheet on page 17. 11a

b Write IRA payments made in 1984 that you included on line 11a. ($)

12 Deduction for a married couple when both work. Complete Schedule 1, Part III 12

13 Add lines 11a and 12. Write the total. These are your total adjustments. 13

14 Subtract line 13 from line 10. Write the result. This is your adjusted gross income 14

⑰

1983 **Schedule 1 (Form 1040A)**

Part I—Interest Income
Part II—Dividend Income
Part III—Deduction for a Married Couple When Both Work

Name(s) as shown on Form 1040A

Your social security number

Test to see when you MUST complete and attach Schedule 1 to Form 1040A

If you—	Complete the following part of Schedule 1—
Have over $400 of interest income	Part I. Interest income
Have over $400 of dividend income	Part II. Dividend income
Claim the deduction for a working married couple	Part III. Deduction for a married couple when both work
Claim the credit for child and dependent care expenses	Part IV. Credit for child and dependent care expenses

Part I

Interest income (See page 13)

Complete this part and attach Schedule 1 to Form 1040A if you received over $400 in interest income. If you received any interest from an All-Savers Certificate (ASC), use Form 1040 instead of Form 1040A.

1 List names of payers	Amount
	$
	$
	$
	$
	$
	$
	$
	$

2 Add amounts on line 1. Write the total here and on line 7 of Form 1040A. 2

Part II

Dividend income (See page 14)

Complete this part and attach Schedule 1 to Form 1040A if you received over $400 in dividends.

1 List names of payers	Amount
	$
	$
	$
	$
	$
	$
	$
	$

2 Add amounts on line 1. Write the total here and on line 8a of Form 1040A. 2

Part III

Deduction for a married couple when both work (See page 18)

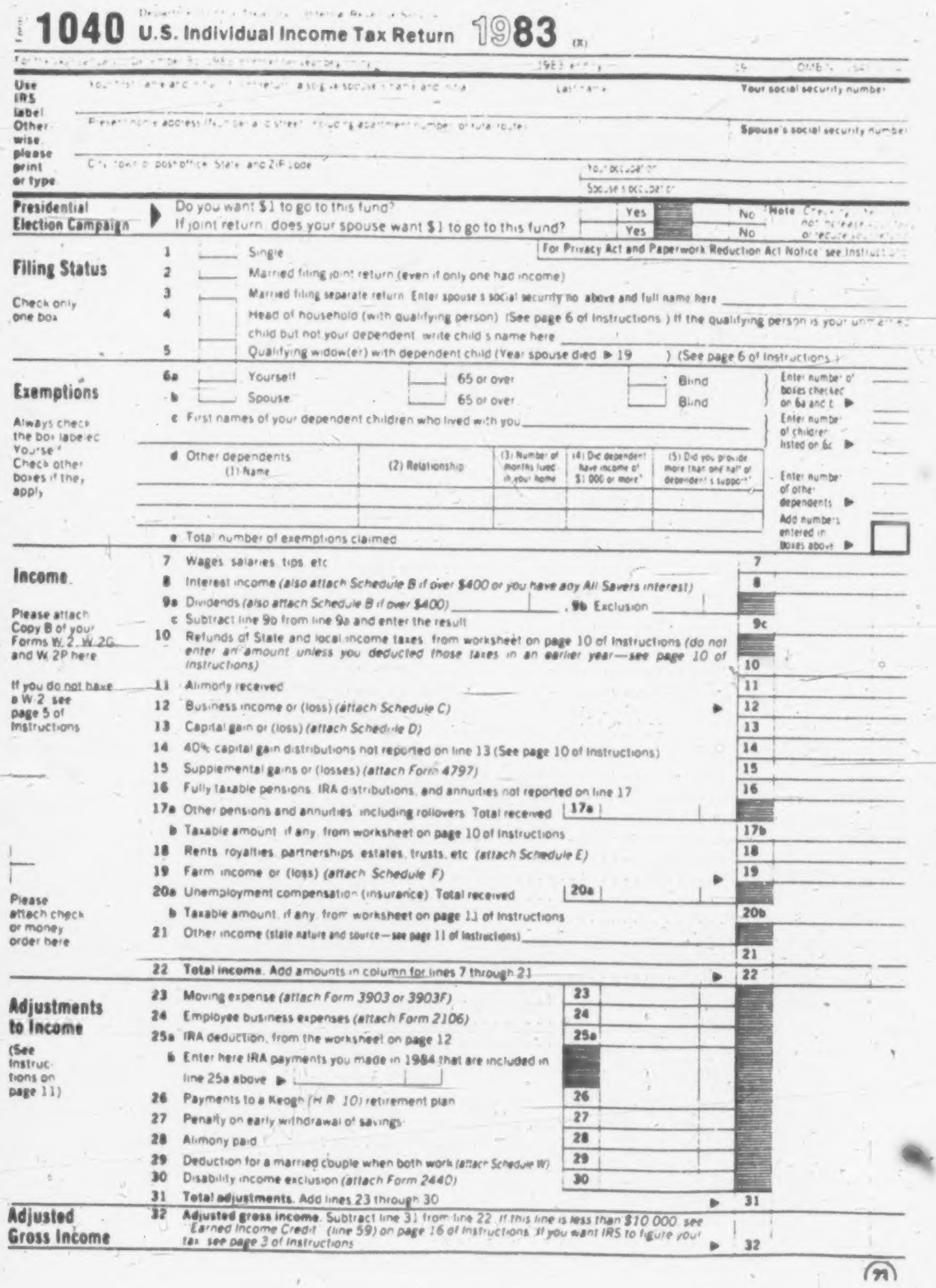
Complete this part to figure the amount you can deduct on line 12 of Form 1040A. Attach Schedule 1 to Form 1040A.

			(a) You	(b) Your spouse
1	Wages, salaries, tips, etc., from line 6 of Form 1040A	1		
2	IRA deduction, from line 11a of Form 1040A	2	−	−
3	Subtract line 2 from line 1. Write the result	3	=	=

4 Write the amount from line 3, column (a) or (b) above, whichever is smaller 4

5 Multiply the amount on line 4 above by 10% (.10) 5

6 Write your answer here and on line 12 of Form 1040A 6 =



Form **1040** [illegible] **U.S. Individual Income Tax Return 1983** (X)

[illegible] 1983 [illegible] 19 OMB [illegible]

Use IRS label. Otherwise, please print or type.	Your first name and initial (if joint return, also give spouse's name and initial)	Last name
		Your social security number
	Present home address (Number and street, including apartment number, or rural route)	**Spouse's social security number**
	City, town or post office, State and ZIP code	Your occupation
		Spouse's occupation

Presidential Election Campaign ▶ Do you want $1 to go to this fund? ☐ Yes ☐ No
If joint return, does your spouse want $1 to go to this fund? ☐ Yes ☐ No
Note [illegible]

For Privacy Act and Paperwork Reduction Act Notice, see Instructions.

Filing Status

Check only one box

1 ☐ Single
2 ☐ Married filing joint return (even if only one had income)
3 ☐ Married filing separate return. Enter spouse's social security no. above and full name here ____
4 ☐ Head of household (with qualifying person). (See page 6 of Instructions.) If the qualifying person is your unmarried child but not your dependent, write child's name here ____
5 ☐ Qualifying widow(er) with dependent child (Year spouse died ▶ 19) (See page 6 of Instructions.)

Exemptions

Always check the box labeled Yourself. Check other boxes if they apply.

6a ☐ Yourself ☐ 65 or over ☐ Blind
b ☐ Spouse ☐ 65 or over ☐ Blind
Enter number of boxes checked on 6a and b ▶
c First names of your dependent children who lived with you ____
Enter number of children listed on 6c ▶

d Other dependents (1) Name	(2) Relationship	(3) Number of months lived in your home	(4) Did dependent have income of $1,000 or more?	(5) Did you provide more than one-half of dependent's support?

Enter number of other dependents ▶
e Total number of exemptions claimed
Add numbers entered in boxes above ▶ ☐

Income

Please attach Copy B of your Forms W-2, W-2G, and W-2P here

If you do not have a W-2, see page 5 of Instructions

Please attach check or money order here

7 Wages, salaries, tips, etc. — 7
8 Interest income *(also attach Schedule B if over $400 or you have any All Savers interest)* — 8
9a Dividends *(also attach Schedule B if over $400)* ____ , 9b Exclusion ____
c Subtract line 9b from line 9a and enter the result — 9c
10 Refunds of State and local income taxes, from worksheet on page 10 of Instructions *(do not enter an amount unless you deducted those taxes in an earlier year—see page 10 of Instructions)* — 10
11 Alimony received — 11
12 Business income or (loss) *(attach Schedule C)* ▶ 12
13 Capital gain or (loss) *(attach Schedule D)* — 13
14 40% capital gain distributions not reported on line 13 (See page 10 of Instructions) — 14
15 Supplemental gains or (losses) *(attach Form 4797)* — 15
16 Fully taxable pensions, IRA distributions, and annuities not reported on line 17 — 16
17a Other pensions and annuities, including rollovers. Total received | 17a |
b Taxable amount, if any, from worksheet on page 10 of Instructions — 17b
18 Rents, royalties, partnerships, estates, trusts, etc. *(attach Schedule E)* — 18
19 Farm income or (loss) *(attach Schedule F)* ▶ 19
20a Unemployment compensation (insurance). Total received | 20a |
b Taxable amount, if any, from worksheet on page 11 of Instructions — 20b
21 Other income (state nature and source—see page 11 of Instructions) — 21
22 **Total income.** Add amounts in column for lines 7 through 21 ▶ 22

Adjustments to Income

(See Instructions on page 11)

23 Moving expense *(attach Form 3903 or 3903F)* — 23
24 Employee business expenses *(attach Form 2106)* — 24
25a IRA deduction, from the worksheet on page 12 — 25a
b Enter here IRA payments you made in 1984 that are included in line 25a above ▶
26 Payments to a Keogh (H.R. 10) retirement plan — 26
27 Penalty on early withdrawal of savings — 27
28 Alimony paid — 28
29 Deduction for a married couple when both work *(attach Schedule W)* — 29
30 Disability income exclusion *(attach Form 2440)* — 30
31 **Total adjustments.** Add lines 23 through 30 ▶ 31

Adjusted Gross Income

32 **Adjusted gross income.** Subtract line 31 from line 22. *If this line is less than $10,000, see "Earned Income Credit" (line 59) on page 16 of Instructions. If you want IRS to figure your tax, see page 3 of Instructions* ▶ 32

Form 1040 (1983) Page 2

Tax Computation (See Instructions on page 13)	33	Amount from line 32 (adjusted gross income)		33
	34a	If you itemize complete Schedule A (Form 1040) and enter the amount from Schedule A, line 28		34a
		Caution: If you have unearned income and can be claimed as a dependent on your parent's return, check here ▶ ☐ and see page 13 of the Instructions. Also see page 13 of the Instructions if • You are married filing a separate return and your spouse itemizes deductions, OR • You file Form 4563, OR • You are a dual-status alien		
	34b	If you do not itemize deductions on Schedule A (Form 1040), complete the worksheet on page 14. Then enter the allowable part of your charitable contributions here		34b
	35	Subtract line 34a or 34b, whichever applies, from line 33		35
	36	Multiply $1,000 by the total number of exemptions claimed on Form 1040, line 6e		36
	37	Taxable Income. Subtract line 36 from line 35		37
	38	Tax. Enter tax here and check if from ☐ Tax Table, ☐ Tax Rate Schedule X, Y, or Z, or ☐ Schedule G		38
	39	Additional Taxes. (See page 14 of Instructions.) Enter here and check if from ☐ Form 4970, ☐ Form 4972, ☐ Form 5544, or ☐ section 72 penalty taxes		39
	40	**Total.** Add lines 38 and 39 ▶		40
Credits (See Instructions on page 14)	41	Credit for the elderly *(attach Schedules R&RP)*	41	
	42	Foreign tax credit *(attach Form 1116)*	42	
	43	Investment credit *(attach Form 3468)*	43	
	44	Partial credit for political contributions	44	
	45	Credit for child and dependent care expenses *(attach Form 2441)*	45	
	46	Jobs credit *(attach Form 5884)*	46	
	47	Residential energy credit *(attach Form 5695)*	47	
	48	**Total credits.** Add lines 41 through 47		48
	49	**Balance.** Subtract line 48 from line 40 and enter difference (but not less than zero) ▶		49
Other Taxes (Including Advance EIC Payments)	50	Self-employment tax *(attach Schedule SE)*		50
	51	Alternative minimum tax *(attach Form 6251)*		51
	52	Tax from recapture of investment credit *(attach Form 4255)*		52
	53	Social security tax on tip income not reported to employer *(attach Form 4137)*		53
	54	Uncollected employee social security tax and RRTA tax on tips *(from Form W-2)*		54
	55	Tax on an IRA *(attach Form 5329)*		55
06	56	**Total tax.** Add lines 49 through 55 ▶		56
Payments Attach Forms W-2, W-2G, and W-2P to front	57	Federal income tax withheld	57	
	58	1983 estimated tax payments and amount applied from 1982 return	58	
	59	Earned income credit. If line 33 is under $10,000, see page 16	59	
	60	Amount paid with Form 4868	60	
	61	Excess social security tax and RRTA tax withheld (two or more employers)	61	
	62	Credit for Federal tax on special fuels and oils *(attach Form 4136)*	62	
	63	Regulated Investment Company credit *(attach Form 2439)*	63	
	64	**Total payments.** Add lines 57 through 63 ▶		64
Refund or Amount You Owe	65	If line 64 is larger than line 56, enter amount **OVERPAID** ▶		65
	66	Amount of line 65 to be **REFUNDED TO YOU** ▶		66
	67	Amount of line 65 to be applied to your 1984 estimated tax ▶	67	
	68	If line 56 is larger than line 64, enter **AMOUNT YOU OWE.** Attach check or money order for full amount payable to "Internal Revenue Service." Write your social security number and "1983 Form 1040" on it ▶ (Check ▶ ☐ if Form 2210 (2210F) is attached. See page 17 of Instructions.) $		68

Please Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Your signature | Date | ▶ Spouse's signature (if filing jointly, BOTH must sign)

Paid Preparer's Use Only				
	Preparer's signature ▶	Date	Check if self-employed ☐	Preparer's social security no.
	Firm's name (or yours, if self-employed) and address ▶			E.I. No.
				ZIP code

㉔

SCHEDULES A&B (Form 1040)
Department of the Treasury
Internal Revenue Service (X)

Schedule A—Itemized Deductions

(Schedule B is on back)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

OMB No. 1545 0074
1983
07

Name(s) as shown on Form 1040

Your social security number

Medical and Dental Expenses
(Do not include expenses reimbursed or paid by others.)
(See page 18 of Instructions.)

1 Medicines and drugs 1
2 Write 1% of Form 1040, line 33 2
3 Subtract line 2 from line 1. If line 2 is more than line 1, write zero . . . 3
4 Other medical and dental expenses:
  a Doctors, dentists, nurses, hospitals, insurance premiums you paid for medical and dental care, etc. . . . 4a
  b Transportation 4b
  c Other (list—include hearing aids, dentures, eyeglasses, etc.) ▶ 4c
5 Add lines 3 through 4c 5
6 Multiply amount on Form 1040, line 33, by 5% (.05) 6
7 Subtract line 6 from line 5. If line 6 is more than line 5, write zero . . . ▶ 7

Taxes
(See page 19 of Instructions.)

8 State and local income 8
9 Real estate 9
10 a General sales (see sales tax tables) 10a
  b General sales on motor vehicles 10b
11 Other (list—include personal property) ▶ 11
12 Add lines 8 through 11. Write your answer here . . . ▶ 12

Interest Expense
(See page 20 of Instructions.)

13 a Home mortgage interest paid to financial institutions 13a
  b Home mortgage interest paid to individuals (show that person's name and address) ▶ 13b
14 Credit cards and charge accounts 14
15 Other (list) ▶ 15
16 Add lines 13a through 15. Write your answer here . . . ▶ 16

Contributions
(See page 20 of Instructions.)

17 a Cash contributions. (If you gave $3,000 or more to any one organization, report those contributions on line 17b.) . . . 17a
  b Cash contributions totaling $3,000 or more to any one organization. (Show to whom you gave and how much you gave.) ▶ 17b
18 Other than cash (attach required statement) 18
19 Carryover from prior year 19
20 Add lines 17a through 19. Write your answer here . . . ▶ 20

Casualty and Theft Losses

21 Total casualty or theft loss(es) (attach Form 4684) (see page 20 of Instructions) . . . ▶ 21

Miscellaneous Deductions
(See page 21 of Instructions.)

22 Union and professional dues 22
23 Tax return preparation fee 23
24 Other (list) ▶ 24
25 Add lines 22 through 24. Write your answer here . . . ▶ 25

Summary of Itemized Deductions
(See page 21 of Instructions.)

26 Add lines 7, 12, 16, 20, 21, and 25 26
27 If you checked Form 1040 { Filing Status box 2 or 5, write $3,400 / Filing Status box 1 or 4, write $2,300 / Filing Status box 3, write $1,700 } . . . 27
28 Subtract line 27 from line 26. Write your answer here and on Form 1040, line 34a. (If line 27 is more than line 26, see the Instructions for line 28 on page 21.) . . . ▶ 28

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Schedule A (Form 1040) 1983

Mr. **Dildine**. Thank you very much.

Before we evaluate the options for simplification reform of the income tax, we think it would be instructive to step back and look at the Federal tax system that is now in place. We have described, at the bottom of page 2, major taxes that are in the existing system.

There are three major Federal taxes—the individual income tax, the payroll tax, and the excise taxes. Now, these are each distinguished by their bases, and by their rate structures. And they are very much different in that regard. The income tax has a graduated rate, and tries to tax all income with certain exceptions; whereas the payroll tax is a flat rate tax. This tax currently imposes a single rate of 14 percent on all payrolls up to an amount of $37,800—a relatively simple tax base. Excise taxes, are somewhere in between. Excise taxes are a series of consumption based taxes, but on specific consumption items, and with a number of different tax rates.

There is the widespread perception that the current income tax is unfair and unnecessarily complex. One of the reasons for this is that we have gone through a succession of attempts to provide important economic and social objectives through the enactment of successive incentives.

These provisions, enacted over a number of years to help a number of different kinds of businesses and social objectives, have also tended to beget one another. To some degree, over a period of time, they have also tended to offset one another. At the same time, their excessive use, or what is perceived to be their excessive use, in some instances has led Congress to enact limitations. What remains is a system that is quite complex and where many of the incentives provided overlap and sometimes offset one another. And yet the perception remains that certain taxpayers are favored over others.

Recent reforms, which often intended to limit abuses and broaden the tax base, have looked at each provision and practice one at a time without much consideration for larger tax principles. The consequence is that while we may have a fairer tax after a given change in the law, it also tends to be more complicated.

Now it seems that before you begin to be negative on the income tax, you ought to consider the one flat tax that we already have. I mentioned it before. We already have a large flat tax in the system. It's the payroll tax. It's relatively simple. It has few exceptions. And it applies to all wages, at least up to a fairly high limitation.

It would be possible to increase revenues simply by raising this flat tax. We doubt that very many people would regard that as a fair approach to produce additional revenue or to simplifying the system.

We have, to a large degree, opted for the complexity that goes along with graduated rates and a much more sophisticated tax base, with some of the complexity required by determining the definition of income in order to tax it.

Now Congress has before it, at the present time, a number of simplification proposals. We do not intend to critique those proposals here. Many of them have been very carefully thought out.

Many of them have been thought out following the kind of procedure that we are going to propose to you this morning.

But it ought to be recognized that these proposals, all of them, continue to have a number of exceptions; most of them at least have more than one tax rate; and most of the changes that would be made by them, if considered provision by provision as they have customarily been in the past, would no doubt encounter a very large amount of political pressure.

Consequently, we suggest a thorough review of the existing system before these proposals are looked at in great detail.

Mr. **Shapiro**. To try to go into what our recommendations will be, page 5 of our outline, we try to set forth a structure of looking at the types of entities that are dealt with in our tax system and which you will have to focus on.

We look at individuals. Individuals, which first include the wage-earner individuals. Then we have individuals that have investment incomes, some for profits and some for sheltering of income. Then we focus on individuals with business income. Then the broad series of deductions, the credits, exclusions, exemptions designed to provide fairness or certain specific objectives that Congress wants to promote through the tax system.

On item two of page 5, we go to business entities. Congress has to focus on the effects of sole proprietorships, partnerships, subchapter S corporations. These provisions essentially deal with individuals because these entities don't pay a tax. The tax treatment of these entities passes through to individuals. And then you must focus on corporations. We have divided these issues into domestic, nonfinancial corporations; multinational, nonfinancial corporations; and financial entities. There are a series of items for businesses that you have to focus on. And then at the bottom of the page, we list a series of miscellaneous entities that also must be taken into account, but primarily we have focused on individuals and businesses.

To give you some indication of a structure for review, we focus on what we have in our system right now. As you will see on page 6 of our outline, we say that the Tax Code itself may help to put into perspective the type of structure that we have.

Attachment A that we have distributed to you, sets forth the Internal Revenue Code by way of an index. There is not an index in the code, as such, because of the way the code is structured. We have pieced an index together to try to give you a feel for the structure of the code and to show you that even if you focus on a flat tax or other alternative simplified tax structure, much of the code will be left untouched by any review that is being presented to you right now.

For example, when you look at the subtitles, you have subtitles A through I. A is the only one that is being discussed. That is the income tax. Subtitle B, estate and gift; C for employment taxes; D for miscellaneous excise taxes; E for alcohol, tobacco, and certain other excise taxes; F for procedure, and administration; and then the joint committee title, Financing of Election Campaign and, finally, Trust Funds."

Subtitles B through I are not being presented before this committee during discussion of simplification. So we are only talking about subtitle A. Under subtitle A, there are six chapters, and we are only talking about one chapter of subtitle A. Granted, it is a very large chapter, but you see we are not talking about self-employment taxes, nonresident aliens and so forth.

Then you get to the meat of the discussion—chapter 1, normal taxes and surtaxes. And only the first two subchapters in chapter 1 are being reviewed with the exception of one or two other chapters, dealing primarily with capital gains.

Let me review the subchapters in chapter 1 because I think it helps put tax reform into perspective. Subchapter A is the determination of tax liability, for individuals and corporations. Subchapter B is the computation of taxable income. This is where all of the perceived complexity, and abuse is essentially contained.

Let us look at the rest of the subchapters and what they deal with. Subchapter C deals with corporations, distributions and adjustments. The Finance Committee' has reviewed Subchapter C but it is a separate issue from the simplifications review of the current tax system. Much of subchapter C needs to be reviewed separately in the type of study that the Finance Committee has been undertaking.

Subchapter D deals with deferred compensation. E deals with accounting periods and methods. F—exempt organizations. G—corporations used to avoid income tax and shareholders. H—banking institutions. I—natural resources. J—estates, trusts and beneficiaries. K—partners and partnerships. L—insurance companies. M—regulated investment companies and real estate investment trusts. N deals with foreign income. O deals with the gain or loss on the disposition of property, which are the basis provisions. P is capital gains. Subchapter P is a subject of several of the bills before you which would repeal the special treatment of capital gains. Q deals with certain readjustments. S is subchapter S provisions for small corporations. T is for cooperatives. U is general stock ownership corporations and title 11 cases is V.

So as you can see, of the entire code that is before you, only a small part of it is being brought to your attention.

This is a two volume Code that we have right now. This is A and B, this part in front. Subchapter C through V is the rest of the Internal Revenue Code. And the second volume is everything other than the income tax. It starts with the estate and gift taxes. It contains subtitles B through I in the first part of the outline. That is the total Internal Revenue Code, most of which is not being proposed to be reviewed for simplification. Although subchapters A and B are the meat of the Code for individuals and the deductions for corporations, you can see how much of the Code remains that deals with the special areas that are in the law, with the special objectives that Congress has enacted over the years dealing with special aspects and fairness for certain industries, and promoting certain objectives in that respect.

Now if you turn to page 4, we look at subchapter B, which is computation of taxable income. There are 11 parts in subchapter B which contains most of the important material for the committee.

The first part deals with definitions—gross income, adjusted gross income, and taxable income. That sets up the structure for the income tax.

Part two deals with the items specifically included in gross income. Congress has spent a lot of time looking at the problems in structure and interpretation and has made a list of items that broaden the base; items specifically included in income. Part three are the items that Congress has specifically excluded. And if you look at that list you will see that many of the items in this list, would still be excluded under any comprehensive tax.

Category four and five deal with the determination of marital status and personal exemptions.

Category six deals with itemized deductions. While Congress will focus on these, deductions many of them will still exist even if you have a broad-based tax for individuals, because corporations still have ordinary and necessary business expenses. And all of these categories essentially deal with business-type deductions that are also made available to individuals in certain cases, such as interest, taxes, and charitable contributions.

Item No. 7 deals with special itemized deductions for individuals. Some of those may be repealed under a broad based tax. Several would not, however.

Item No. 8, special deductions for corporations.

No. 9 is a long list of items that Congress has said are not deductible. Once again, a definition of a broad base. And Congress has already spoken in those areas.

And then we get to minor areas.

Look at the bottom of this page, part 2. These are the items that Congress has already acted on which in effect broadens the tax base—section 71 all the way through to section 87. These include the special areas that Congress has taken into account, such as alimony, annuities, services of child, prizes and awards and so forth.

Turning to page 5, there is a list of 34 items that Congress has excluded from gross income—death benefits, gifts, and inheritance, interest on Government obligations, compensation for injuries and sickness. And they go on and on. Many of these items, once again would still be excluded from gross income under any comprehensive tax structure.

Now to the next page, No. 6 These are itemized deductions for individuals and corporations. Almost all of these items on this list, sections 161 through 196, would still be in the law because they are deductions for individuals. Even if they are not allowed for individuals as itemized deductions, they would still be allowed as deductible of business expenses such as section 162, interest, taxes, losses, bad debts, depreciation, and so forth all the way through this point. And these are the itemized deductions that are available to both individuals and businesses. It may be simplified to some extent, but if you allow businesses to offset their deductions of doing business, they would still be here.

At the bottom of the page is a list of special deductions for individuals. Section 212 is for the expenses for the production of income, essentially investment income which would still be allowed. And then you have to review some of the others. Retirement savings is 219. Deduction for two wage earners is 221. And then you have adoption expenses.

On page 7 are the special deductions for corporations. Now, lets go to No. 9—items not deductible. Congress has already listed a long list of items which are not deductible and thus broaden the base. This means that you have already reviewed these items and have concluded that they are not deductible. They would still be in the code, after the enactment of any new top simplification structure.

Let me stop here. The last several pages deal with basis and capital gains to show you some of the provisions that are needed, even though they are complicated, to determine gain or loss on any sale. Much of this would be necessary whether or not you have a capital gains structure.

The other areas that I wanted to focus on for simplification purposes is attachment D, this is a portion of an Internal Revenue Service publication called "Package X, Information, Federal Tax Forms." What we have photostated for you is just a couple of pages of package X—the front page, inside cover, which shows you the table of contents. Following the table of contents are six pages which are at the end of the package X document. These pages include the more commonly used principal Federal tax forms. Under any comprehensive tax system, most of these forms would still be used. I'm trying to point out that although we still need simplification, a lot of these forms are necessary in the system for the cases that would apply in any type of system, and we will have to assist taxpayers in having forms to keep their records. If you look through the list of these forms, in front of you, you will see that most of them will still be necessary.

The last page is just a table of contents of package X.

Other items are listed, just to give you a flavor of our tax form structure, which most people view as the complexity of the tax system. Attachment D, which focuses on the three basic forms for individuals—1040-EZ, 1040-A, and the 1040, and compares each one. This description comes from package X. It shows you who can use 1040-EZ, which is only for single people who earn less than $50,000 of income and who have limited types of income.

Then you have 1040-A, which can be used by single, married, joint returns, under $50,000. You can have interest, dividends, plus wages, and no itemized deductions. And once again, package X says who can use it. And then you have the list for 1040, as a comparison, and a description of everybody else who can use that form.

I'm not going to review the rest of the attachment which includes the forms. The 1040-EZ was designed to be simple. It has big boxes and one page. Then the 1040-A, and we also photostated the 1040, front and back, plus the schedule of deductions.

These pages show you the structure of our system, trying to give you a feel for how it is set forth.

Larry Dildine is now going to go over some of the types of data that have been put together, to show you which items are commonly used and how many taxpayers use these forms.

Mr. DILDINE. Thank you. We have just a few numbers here. They appear in attachment C, which is the next to the last item in your package. These figures illustrate some of the issues that Senator Long spoke about a while ago. They show who uses what tax returns and how many items are used by the various individual taxpayers.

You have just looked at the tax forms. The new 1040-EZ, a very simple tax return was used by about 17 percent of tax filers in 1983. The 1040-A, the short form, was used by another 21 percent. So you have about 38 percent of taxpayers who can use a shorter form. A good deal of simplification is there already.

The remaining 62 percent of taxpayers used form 1040. But among those, only 57 percent itemized. The remaining taxpayers used the 1040 either because they find it more convenient to obtain one or they have items of income or adjustments to income that are not included on the 1040-A.

Among those who itemize deductions, a little bit more than a quarter, 26 percent, would not itemize deductions were it not for their home ownership.

Senator LONG. What percent?

Mr. DILDINE. Twenty-six percent, according to our information. So you have a total of about three-quarters of individual taxpayers, 74 percent, who either do not itemize or would not itemize if it were not for their home ownership.

Looking at attachment C, we have filled out what looks like a 1040 form, but we have put on it the percentage of individual taxpayers who report each item from all tax schedules. This shows, for example, that 88 percent, nearly everyone, has some wage and salary income. And about 36 percent report taxable dividends and interest. After those two items, the numbers become very small. Indeed, there is no other item of income besides dividends, interest and wages that is reported by more than 15 percent of the population; 10 percent of the taxpayers report business income. Ten percent report capital gains. And 15 percent report income from royalties, partnerships, and so on.

When you look at individual taxpayers who are primarily wage earners, whose main source of other income is in the form of interest and dividends, you are accounting for a very large proportion of the total taxpaying population.

Now based upon all of the foregoing, we do have some recommendations to suggest.

Mr. SHAPIRO. Our recommendations begin on page 8. We will try to provide some background on the structure of our system.

Senator LONG. Page 8 of what, Mr. Shapiro?

Mr. SHAPIRO. Page 8 of the outline. I'm sorry. We are shifting on you. It reminds me of the old days when I had all these papers spread all over.

We have discussed by way of background that the tax law is complicated, and it will remain complicated. Although the filing of tax forms can be simplified for more people, the issue of fairness is a major concern. And, therefore, we have tried to set up a structure of recommendations as a way it may be approached by the committee to review a reform simplification package in an orderly way.

First, we are saying is that it should be done without revenue considerations and without a deadline. If you do not have to focus on raising revenue and you do not have a time pressure to meet a certain deadline, it will be possible to have a more thorough process of reviewing the system, especially in the way that we are proposing a schedule.

It should be done by the tax writing committees and their staffs, working with the Treasury and the appropriate tax community—practitioners, business community and so forth. The purpose of the review is to do it in a balanced legislative package; not just a study; not a commission report; and not in a piecemeal approach. Piecemeal approaches present problems. You should do it in a way to have the same relative burdens by income classes and all the basic objectives—simplicity, fairness and so forth.

Now item No. 4 at the bottom of page 8 is what we are really trying to focus on. And that is it should be done in a number of stages, focusing on a broad group of taxpayers. We have tried to provide the data to show you where most of the taxpayers are affected in the tax forms, and we have found that most are affected primarily by wage income. After wage income, the numbers fall off drastically as to how many people fill in which forms and which part of the schedules.

If you begin by looking at the broad group of taxpayers and look at the rates and exemptions and the revenue levels at the end, it will give you a better opportunity for a balanced package.

On page 9, we start off by reviewing this structure, looking at the concepts of our tax system, which is in B-2, gross income, above the line deductions, adjusted gross income, itemized deductions, taxable income, and then credits. Then we get to the first stage. This is the most important stage. Wage and salary earning households, without considering rates or revenue. This is the most important group, and is the largest group. This deals with subchapters A and B that were referred to, which is a relative small part of the code, but this is the part of the code that affect these people.

You look at how easy it is, the simplification in filling out the return and the equity issue. Then if you go to stage 2, which is on page 10. That deals with the next category—households with substantial investment income. These are the people who make investment and the treatment of this group brings in additional complexity. And that's where you get into the sheltering. People also make investments; tend to look for tax shelters.

Tax shelters have three basic elements. And that's in 2-A, B, and C. First is leverage, the use of borrowed funds, second is deferral, the use of accelerated deductions; and third is conversion; converting ordinary income to capital gains. The committee should review these elements in an overall, rather than piecemeal, approach. It doesn't mean you leave tax abuses alone, but you do what you have done in the past, which is look at each one. But to try to get an overall review of our tax shelter aspect, you must look at the basic objectives in this category: economic efficiency and equity. Complexity is not a major issue with the group of people who make investments for tax sheltering. Instead, economic efficiency is the important concern.

The area of capital gains is described on page 11. Capital gains is a very sensitive area. It is a major source of complexity, and yet at the same time, it's an important incentive for risk taking. It also deals with the fairness issue of the effects of inflation. It requires a significant review by the committee in order to make the major decisions whether to repeal or cut back the current capital gains treatment. There needs to be an analysis of the overall effects of capital gains treatment.

Larry will very quickly summarize the nonfinancial section of this outline, and then we will be happy to answer any questions.

Mr. **Dildine**. The third stage of this review—and this is a difficult one—is the complete review of the taxation of businesses, leaving aside for the time being special rules for financial institutions and foreign transactions, but looking at businesses of all kinds—corporations, partnerships, proprietorships, and subchapter S corporations. The rules that you have for all of those, if not the rates, are going to be essentially the same.

The objective of the review of businesses has to be primarily to look at economic efficiency questions, to reduce the intrusion of taxes on business decisions, to get businesses to concentrate more on making widgets and selling them rather than worrying so much about their taxes, to avoid directing scarce capital to less productive uses. We believe that capital allocation should normally be left to the market. The tax system would provide incentives only where market incentives are insufficient.

There are also fairness issues here. You have heard today, and I'm sure you have heard many times in the past, a good deal of complaining about different treatment of different kinds of businesses. Some of that may still exist and ought to be reviewed.

We think that it may be possible after such a review to offer the business community a trade—reductions in corporate tax rates and the top individual tax rates in return for including a larger amount of business income in the tax base, and the reexamination of the business tax structure. Properly balanced and presented, this could be a viable proposal.

In addition, we know this committee has already looked at subchapter C reform, and may also want to include such discussions in a review of corporate taxation. As a further step toward integration of the corporation and individual taxes, you may wish to investigate further expansion of the provisions of subchapter S.

Following that, and using essentially the same principles, we would suggest taking up the special rules for financial institutions and for international transactions as a fourth phase. This leaves to the end the review of the significant issue of tax rates. Only after the base has been considered fully should it be necessary to consider different revenue targets. Revenue targets can be reached by adjusting rates, given a simpler, fairer, more efficient tax system.

At the end of our outline, on page 13, we do suggest that once you have taken this complete look at the income tax, the revenue question remains. The revenue question, however, then comes down to a question—whether to use another tax, another section of an Internal Revenue Code to define a new tax such as a VAT, or instead, to use this improved income tax as the principal source of additional revenue if that becomes necessary.

Mr. **Shapiro**. The last page of our outline reviews a number of questions posed by the Finance Committee in their press release on these issues. We have dealt with those questions. And I think there is no need for us to summarize it at this point.

That concludes our presentation. We would be very pleased to respond to any question or issues you would like to raise.

Senator DANFORTH. Thank you very much. It was very helpful. Senator Long.

Senator LONG. I have some questions to ask, Mr. Chairman. I notice that there is a vote going on on the Senate floor right now. I think other members might want to ask some questions of these two witnesses. I wonder if we might just go over to vote and then come back and ask our questions.

Senator DANFORTH. I cannot come back unfortunately.

The CHAIRMAN. I can't come back, but I think Senator Long can.

Senator LONG. In that case I will go vote while you two ask your questions. I'll be back.

The CHAIRMAN. We have a chairmans' meeting at 11:45. We just need to plan our strategy for the balance of the year. It shouldn't take long. [Laughter.]

Senator DANFORTH. I will just ask you one question. You know, it is said, well, the tax forms are simple for the average person. It's just a one page form. So what is the talk about simplicity? And then you say that as far as business people and investors are concerned, simplicity is really not a big problem for them. So how would you answer that question? What's the problem? What's all the talk about simplicity?

Mr. SHAPIRO. I think we are talking about several factors, Senator Danforth. First of all, I don't want to leave the impression that simplification is not important. But it is not as important as other consideration. It's a secondary factor. When businessmen and investors make decisions that tend to involve complicated investing patterns, they are going to have complicated tax provisions to deal with. The tax laws have to cope with a number of the more complicated types of transactions that have been going on in recent years—the tax laws have been trying to catch up. Each time the business or investment community creates more complicated transactions, the tax laws have to adjust to deal with them, and it increases the complexity.

So I don't want to say that the tax system should be complicated. I'm just saying it's a result of complicated transactions in many cases, which is not all tax motivated.

I think the concern is probably more with the perception of fairness. The issue is that when you have very complicated laws, the feeling is that people aren't paying their fair share. Even though the law may be simpler for the average taxpayer, as long as the form is simple and they just fill it in, many are still concerned that while they may be paying their fair share, other people are not. And complexity increases their perception of unfairness.

Senator DANFORTH. I think that that is part of it. In think, in other words, for the average person, they will say this is a simple form for me to fill out, but the other guy has got a complex form and that allows him to take advantage of all kinds of loopholes that I don't get on my little form.

Mr. SHAPIRO. That was the point I was trying to make.

Senator DANFORTH. I think there are two other points, and that is that we attempt to make public policy by writing the tax law. And this is an attentive committee. This is a hard-working committee. We spend maybe a month at hearings or markups to write a tax law. But the idea that we know the effect of a 1,300-page bill when we pass it is just not true. No matter how hard we work at it, no matter how attentive we are, to be able to figure out what the effects are of what we did, I think, is impossible.

And I would say that the third point is that if you are going to have all this complexity, people manage their affairs in the right way, they could take advantage of it, it puts a premium on not how energetic the American people are or how bright they are, but whether they are able to get Price Waterhouse or somebody else to outline for them all the different hoops they can leap through in order to minimize their taxes.

Mr. **Shapiro**. That was the point we were trying to make too. When you have reviewed the tax system and you look at the individuals beyond the wage earners who make investments, you must look at the investments for profit separately from investments for shelter. To the extent that investments are sheltering income, there is a concern for the fairness issue. But it is a very complicated issue, and it requires complicated results. I don't see how you can avoid dealing with it.

Senator **Danforth**. Thank you very much. Senator Dole.

The **Chairman**. I apologize for not being here earlier, but we have had a number of meetings this morning. I know this has been a fine presentation. It will be a significant contribution.

I think sharing Senator Danforth's views—we've had a number of witnesses proposing all kinds of flat, fair, simple, fast, all kinds of tax changes that would simplify the Code. And I think you have demonstrated rather clearly we wouldn't simplify very much of it. But you don't take any strong position for or against any of these ideas that are running around the capitol, do you?

Mr. **Shapiro**. Mr. Chairman, we don't because it would be presumptuous of us to do so having served with the committee for so many years. No matter what proposal comes to you, the committee, in its wisdom, reviews it and makes the appropriate changes. I think the sponsors of these proposals can be commended for being able to put on the table broad proposals for the committee's review. Ultimately, the committee has to review the objectives of these proposals and they must decide how the tax system can be fashioned in providing a simpler structure for the mass number of average taxpayers. Then the committee should start looking at the complexity issues, where it is warranted. I think it's presumptuous of any of us in the abstract to start deciding which one is good and which one may be bad because there are multiple considerations which the committee in the past and in the future will review for making their decisions.

The **Chairman**. I agree with your recommendation that we ought to have a careful review and it shouldn't be piecemeal and there shouldn't be any time constraints. As long as it's revenue neutral, you wouldn't have that problem.

I'm not certain there will be a recommendation or at least a report from Treasury in December. They have been going through the same process in not having the foggiest notion what they intend to recommend.

But it would be my hope that we would proceed with a review, outline where we want to go, have the cooperation of the tax writing committees on both sides, and Treasury and others, as well as outside sources. We will be looking both to you and others in the audience and elsewhere to help us in that effort.

But it would be a massive undertaking. Do you have any idea—you say no time limit. What do you think it might take to really do a thorough job?

Mr. **Shapiro**. Well, it would take a long time. The process is now much more complicated. As you know, when I first came to the staff, the congressional committees did not have subcommittees. They reviewed a tax bill, or a Social Security bill, or trade bill in the full committee. Times have gotten more complicated and now alternative ways to deal with tax review are required. Thus, the subcommittee approach is necessary. There are also severe time pressures.

There are many ways to set a schedule. I think the process has to start with the committees. If the process starts from the outside there are just too many alternatives to consider I would like to see the committees being able to decide their approach and to design a structure for the review in an orderly manner.

The **Chairman**. I know we have about 4 minutes. I'm just going to recess until Senator Long arrives. And he has some questions. We do have a chairmans' meeting, and I will not be able to come back. Neither will Senator Danforth. Senator Long can take over and just practice a little in case anything happens in November. [Laughter.]

But we have 1 more day or morning of hearings scheduled. On the 20th will be the final 2-hour session on just looking at different options.

We do appreciate your testimony and other witnesses who have been here this morning.

Thank you very much. We will stand in recess until Senator Long arrives.

[Whereupon, at 11:46 a.m., the hearing was recessed.]

AFTER RECESS

Senator **Long**. I ask the witnesses to return to their seats, and all those in the room take their seats or find a seat.

First, let me thank you, Mr. Shapiro, and your associate for the magnificent presentation you have made here before the committee today. I think that this material is very helpful to us. You have obviously spent a great deal of time preparing this information and it also gives the committee the benefit of matters that you have been thinking about for a great number of years.

How long have you been thinking about these matters now, Mr. Shapiro?

Mr. **Shapiro**. Having served with the Joint Tax Committee staff for some 15 years, I have continued to focus on tax policy and tax simplication from the time I left the staff in early 1981. It has been a continuing involvement. Having been involved in the process as long as I have and working with the committees, you get very close to the system, and you develop a concern about tax policy.

Senator **Long**. I think that you have really given us some very fine suggestions on some ways we might go about this.

Here is one of the thoughts that occur to me along this line. If we followed your suggestions and your recommendations, it would take a very long time. If we undertook to follow your procedure and cover the items that you have in mind and take the time to do it the way you suggest it ought to be done, how much time do you envision that taking? You have been up here. You have worked on the Hill. Your associate has worked in the executive branch. How long do you think it would take to do the job that you are suggesting here?

Mr. SHAPIRO. It would take a fair amount of time, Senator.

Senator LONG. We are not talking about days. I'm talking about years.

Mr. SHAPIRO. I would say that it would take more than a year at a minimum. I will say, however, that there have been a lot of people that have made suggestions for the last number of years that there should be a moratorium on tax legislation to allow the Congress to have an opportunity to review what has already been enacted without the pressure of having to consider a major tax bill every year. Political pressures and economic pressures have not permitted that, of course. And, therefore, we have had thousand-page tax bills that continue to be enacted.

If Congress were able to put aside revenue restraints, that are still before you, in order to let the practitioners cope with what is already in the system, the Congress could look ahead to the designing of a simpler system by having an opportunity to focus on the current tax system. Thus, if the review process were properly structured with the appropriate subcommittee or task force review that combined the congressional staffs—the Finance staff, the Ways and Means Committee staff, and the Joint Committee staff with the staffs of the administration, and the professional organizations, the Congress could have a periodic review of how its objectives coincided with suggestions and recommendations. In other words, the Congress should not wait until everything is in place, but should constantly review the members' opinions in order to obtain some reactions.

I am concerned that if you wait until the process is completed, everyone will have alternatives to change this piece and change that piece. Instead, the Congress should modify the reform package by looking at considerations and tradeoffs throughout the process.

I would like to suggest that as you focus on one category that there be frequent committee and member review of that particular stage. It is essential that the views of the committee members are obtained.

But I must admit it could take 1 year to 2 years. And I'm just saying that without knowing how long. I don't expect it to be done very quickly. It shouldn't be done very quickly.

Senator LONG. It looks to me more like a job that would take 4 years.

Mr. SHAPIRO. Well, it depends on how much you want to do.

Senator LONG. You are talking about giving the commissions the opportunity to participate. That's implicit in your recommendation here, isn't it?

Mr. SHAPIRO. I think you would want to get some of their perspectives as well.

Senator LONG. You would give the Tax Section of the American Bar Association an opportunity to participate, I would take it?

Mr. SHAPIRO. You have got some very fine professional organizations with dedicated people who can make a contribution to the process.

Senator LONG. Would you envision that they would have time enough to take a position on the recommendations, that is, to discuss them and take a position on them. If so, that takes time.

Mr. SHAPIRO. Yes. And yet sometimes it works more effectively if you try to focus on and pick out some key individuals in those organizations who can speak on their own. Many times these professional organizations have such bureaucratic procedures that in order for them to be able to make a statement, it requires 6 months to get the statement approved within the organization. Therefore, by picking out some of the people who have a contribution to make, as the committees have done in the past, it appears as if these people representing the organizations, but in reality they are speaking for themselves because the organizational process takes too long and may restrict some of their positions.

Senator LONG. I'm just trying to get a picture of where we come down by the time we get through with that. You don't want to prejudge what the final package is. But I think it helps us to just try to guess at it as to what all this would look like by the time we get through.

Would you assume that by the time we get through with our review we will have a much smaller percentage of people who itemize than we have at the present time?

Mr. SHAPIRO. That is hard to project because the interest rates have recently increased to a very high level which means that currently more people are itemizing than they would if the interest rate were 5 or 6 percent. In other words, one of the major reasons for itemizing deductions is the interest rates.

I don't feel that itemized deductions per se is the complexity in the system. You can separately analyze the itemized deductions, as Congress has already reviewed many of these deductions. In the case of the medical expense deduction, Congress has already limited it to the catastrophic level for social purposes to assist these taxpayers in very special cases

Interest is also a deductible item. Yet the deductibility of interest is considered fair because we only borrow money to use it for consumption, savings investment. Furthermore, the treatment of the sales tax, can be complex in order to ensure fairness. A taxpayer has the option to use the sales tax tables, which is a very simple task to determine the sales tax deduction, the taxpayer only has to look up the amount of income he makes, take the amount listed on the table and plug it into his tax return. And yet for fairness, we admit that some taxpayers actually spend more money on consumption during the year than the amounts listed in the table. Thus, the taxpayer is permitted to keep records in order to deduct the actual sales taxes. This process adds complexity, but it's fairer.

In the area of charitable contributions, we can have a much simpler system if we allow deductions for only cash contributions. This limitation would eliminate the problems of property donations, because taxpayers could not overestimate the value of their donations. For example, at the end of the year people frequently donate clothes and pictures and because these donations require subjective evaluations and guessing, there can be a lot of overestimation on the valuation for the tax return. And yet if we don't allow property donations, a lot of charitable organizations would not be getting some of the charitable gifts that they might otherwise obtain.

Futhermore, most of the simplified tax proposals allow a deduction for charitable contributions and allow the deductions for home mortgage interest.

Thus, I would expect that when you finish a comprehensive review of the tax system, you will still have several itemized deductions. Even if you eliminate some of the deductions, I'm not necessarily sure that the elimination will be providing that much more simplicity.

Senator LONG. According to your testimony here, it would drastically reduce the amount of itemizing if you had, as I suggested in the previous questioning, a form that related to the needs of people who pay interest on a home mortgage. Perhaps if you had a separate form for one to deduct interest on a home mortgage, it ought to permit the deduction of all interest expenses. Does that make sense?

Mr. SHAPIRO. You are saying treat mortgage interest on the home separately from other interest?

Senator LONG. Well, my thought, in hearing the testimony presented here by the two of you and also in the discussions down through the years, is that the largest single item that causes people to itemize who otherwise would not itemize is the deduction of the interest expense on a home mortgage. That's what you have testified to us here today and that's what I've been hearing all down through the years.

Assuming that to be the case, if we simply had a form in addition to the 1040-EZ and the 1040-A, if we had an additional form, that was just directed to the needs of someone who has a home mortgage and who has a high interest expense, I assume that you would give that person a smaller zero bracket amount because he would be foregoing this principal item that he would otherwise itemize.

Mr. SHAPIRO. I understand your point. I'm going to let Mr. Dildine respond. I believe you are saying that if you remove the major item that requires people to itemize, and let them deduct it separately, they wouldn't have to worry about the rest of the itemized deductions.

Senator LONG. We would give you a form where you don't get as much of a zero bracket amount as you otherwise would get, but we are going to let you itemize this one item that is important to you, the interest expense in this case. Perhaps it should be all interest expense rather than interest expense just on a home mortgage—that's a question I would like to ask you and get your thought on.

But in either event, let them itemize this item of interest expense that otherwise would require them to itemize everything that is available to them under the ordinary form 1040. And by doing that, it would seem to me that they wouldn't have to worry about all the other expenses they could itemize. They would just worry about that one. Hopefully, they would come out better by itemizing just that one and taking the benefit not of the full zero bracket amount, but of enough of it so that it would be worth their while to itemize just the one item and to choose that form.

Now if you did that, it would seem to me that you could take all these people that you are saying are itemizing to claim that one deduction, and give them the benefit of simplicity, and yet let them itemize just this one item, of interest expense. And it would seem to me as though you would have vastly simplified the whole process as far as those people are concerned because they could fill out their own tax return. I'd like to get your thoughts on that.

Mr. DILDINE. We estimate that if you had that in addition to the standard short forms that we now have, those altogether would cover about 75 percent of the taxpaying public. Now there are some concerns that I know the Internal Revenue Service has about the inclusion of more and more different kinds of forms. On the front of package X, for example, they complain publicly that a lot of people who could use the EZ form don't. It is something of a problem to get everyone to use the right kinds of forms. And, obviously, the more such forms you have, the more difficult that would be.

I would make two suggestions here. One would be that a lot of people would feel compelled to fill out every one of the forms until they found the one that did the best job for them. That would not necessarily be a simplification.

Second, for most people who have home mortgage interest, virtually all of them will also have a property tax deduction. They might feel the necessity to take both of them at once. There is a large share of the population who, itemize because they have a large mortgage. This is what puts them over the threshold. After that, however, they look to see how many of the deductions they could find. Your suggestion would moderate that to some extent.

Senator LONG. It just seems to me that if he he is an ordinary wage earner with no home mortgage that is one thing. But the law is sufficiently complicated that almost anyone who has any investments at all, if he has an income tax that is substantial relative to his income, he ought to talk to someone who is an expert on taxation. Now it might be Price Waterhouse, or it may be Price Waterhouse wouldn't want to fool around with his concerns. It might be just a guy who hangs a shingle out and who doesn't even have a college degree but is permitted to advise taxpayers and who has read quite a bit of material about the tax laws.

But anybody who had any knowledge at all about it, if he were advising a taxpayer who has just one big item of expense that would be deductible, interest on a home mortgage, he would advise that fellow, after he looked at what his affairs appeared to be, that he ought to ask for this particular form. That would be all that fellow needs until his business becomes a great deal more complicated than it is now.

I don't know why we don't provide such a form for a person in that situation, and thereby enormously reduce the complexity. I think you said that is 26 percent of all taxpayers itemize. Is that right?

Mr. DILDINE. Yes, sir.

Mr. SHAPIRO. Senator, let me briefly summarize my reaction to your comments. Your intention is to try to allow people fill out their forms a little bit easier so that they wouldn't have to take into account all the detailed schedules and the forms. I know you have been dedicated to that objective ever since we have been talking about tax policy.

I believe that there would be a tremendous amount of political pressure from charities to allow a charitable contribution for whatever tax form you create for taxpayers that own homes. Charitable organizations would demand the same treatment. Otherwise, people may not donate to charity. Taxpayers would lose the incentive to contribute. You will always be exposed to that type of pressure.

I also agree with the point that Larry discussed. We find that taxpayers today don't always feel that they are helped by forms that are simpler because they are worried that they may not be taking full advantage of all the possible deductions.

For example, there are three basic forms today for individuals—1040-EZ, 1040-A, and the 1040. The taxpayers are concerned that if they fill out the 1040-EZ or the 1040-A, they may be missing something that may reduce their taxes. The Internal Revenue Service has submitted data to show that a number of people fill out the 1040 who don't need to. In some cases, taxpayers don't have the other schedules and it is easier for them, and in other cases they want to see if the 1040 will cause them to pay less taxes. Some taxpayers actually itemize their deductions to see whether they benefited or not. Thus, it may not be beneficial to provide another option. Although this option would take a lot less time and would help many people in filling out their form, taxpayers would be apprehensive of the option. Many times, even though taxpayers may want to prepare their form themselves, they may hire tax return preparers who say that the tax laws are complicated because there are three, four and five schedules. How do you know which form is best for you? The advertising by tax reform preparers would encourage a lot of small taxpayers to purchase their services because taxpayers will want to be certain that they are actually paying the least amount of tax—and these small taxpayers are exactly the people that you are trying to help.

This type of scenario has been a concern with the adoption of many options. Anytime we give taxpayers options to try to make it easier for them, we find out that they tend to try all the options, and thus, we add to their complexity in an effort to help them. That is clearly not our intent.

Senator LONG. It seems to me that most people should at some point seek advice when they start paying this Federal income tax. If it's not anymore than 1 or 2 percent of their income, I can see no point in them getting upset about it. But what they are paying in taxes becomes a substantial portion of their income, they ought to talk to somebody who is an expert on the subject.

Whoever that somebody is, he ought to advise them. He ought first to get the facts about their situation. Let them provide—tell how much income they had, what their expenses were and get an overview of what their problem is. And having done that, he should advise them which one of the forms they should use now. Now that's a decision the taxpayer has to make right now about which one of those three forms he wants to go for. It seems to me as though you ought to be in the position to advise him which form he ought to use and to show him how it ought to be filled out.

Now if all he has got is interest on a home mortgage, I don't see why he has to keep coming back to you to seek your advice. It seems to me that once he understands that here is this one big item that he is entitled to deduct, and this is the form that is most to his advantage, I don't know why he has to come back.

Now there may be some tax services who would want to try to find some way to keep the guy coming back because he pays a fee. I don't think your firm is in that particular business. You have plenty of business without having to find it that way.

But certainly doesn't the Government have a service of helping taxpayers fill out their tax form? And can't you go down to the post office at about taxpaying time and get somebody to help you fill out your tax form?

Mr. **Shapiro**. The IRS has taxpayer assistance, but over the years that budget has been cut back so it is not as prominent as it used to be. They used to provide more assistance to taxpayers.

I will say that one of the problems, of course, is also the fact that when you have a tax change every year, taxpayers get concerned that there are new things they don't know about, and they need to check with someone to find out if something was enacted that could benefit them. So if you slow down the process by not having a major tax bill every year, taxpayers would be able to go from year to year knowing that the deductions allowed last year are the same for the next year. But if there is a new tax bill every year, they are going to keep going back to the practitioners wondering if something was enacted that would help them. That is the concern or problem with a major bill every year.

Senator **Long**. I agree with you on that. But if I picture where I think we would come out if we do everything you are advocating, it seems to me that somewhere down the road you would come out with a tax system that is simpler or easier to comply with as far as the average fellow is concerned. I see one of you nodding.

How do you feel about that, Mr. Shapiro? I mean the average guy who doesn't fill out the 1040-EZ but maybe the 1040-A. Would you anticipate if we do what you are suggesting that by the time we are through with all this that we will have a system that is simpler for the ordinary guy who is filing the form 1040-A?

Mr. **Shapiro**. I would hope so. I hope that it would be simpler, and I hope that there will be the perception that the system has been reviewed from a fairness point—and I don't want to underemphasize that a major issue facing the Congress right now is the perception of fairness. For most taxpayers, filling out the tax return isn't the problem because the great majority of taxpayers who have essentially wage earning income and small amounts of other income, use either the 1040-EZ, the 1040-A and even for those who may use the 1040 it is not very complicated for those situations.

The basic concern is that you have added a tremendous amount of complexity for many of the nuances in business transactions, tax sheltering, and so forth. But you are dealing with people who are designing business transactions that necessitate complexity.

The biggest problem that I think you are facing in of your hearings and when you go back to your States and your districts is the perception of fairness. There is the fear that somebody who fills out more pages in the form, has some advantages that another person doesn't have. Even though the tax form may be simpler for those particular individuals, they would like to know why they are not getting some benefits others are getting, and why they are paying more than they should.

I would hope that a comprehensive review of the system would bring back an aspect of fairness so that the issue of perception can be dealt with.

Senator LONG. It seems to me that—for example anybody I talk to for a chamber of commerce group or a civic club, the complexity is a problem. As far as they are concerned, the complexity is one of the severe problems. Now do you agree that, for those who would attend a chamber of commerce meeting or be in the audience in the ordinary civic club, complexity is going to be a big item?

Mr. SHAPIRO. Senator, it is a big item, but I will tell you that complexity is an issue because over the years we have been having a piecemeal approach. Everytime there is a problem we have been putting a patch here and a patch there because of time pressures. Furthermore, the staffs and the Congress have not had the opportunity to review the tax system comprehensively and they have not provided a structure that could deal with the problem in a more simplified manner. During the last tax act, there were tremendous time pressures that the Congress and the staffs had to deal with. Thus, when you have seen a problem you have patched it, rather than conducting an overall review of it.

I would also make a point that in all of the years that I was on the congressional staff, I found that when I spoke to these groups, like the chamber or whatever business group, about a provision that was a benefit to them, the complexity wasn't an issue. Complexity is only an issue if the tax reform takes something away from them and in turn, provides a complex solution. In other words, if the provision is a reform that raises taxes, complexity becomes a problem.

I could recite a number of areas in the tax law where benefits are provided to the business community, and no one is complaining about the complexity. They would like it to be a little bit simpler, but if you are going to simplify the tax system by taking away the benefits, the complaint about complexity isn't as great as the concern for the results. And this doesn't mean that the benefit is a loophole. What it means is that Congress has enacted a provision to provide a desired objective. Providing that desired objective could be complex. But it provides a benefit believed appropriate by the Congress.

Senator LONG. You say you could cite many examples. Would you mind giving us a couple of examples of that that come to your mind?

Mr. SHAPIRO. Well, I could describe one, but I don't want to provide a litany of examples. In 1971 the proposed DISC provisions added a benefit for exporting. And, as you know, there was a tremendous debate in the Congress as to whether or not these provisions were appropriate. The end result was a complex set of rules, but the legislation provided a benefit. And the business community thought that it was an appropriate incentive to encourage exports, which was the basic reason for the provisions. The legislation was not dealing with fairness. It was not dealing with simplicity. The primary goal was economic efficiency. The legislation was trying to promote exports because we were concerned about balance of trade.

Over the years we have provided a number of modifications to DISC, much of which were designed to provide fairness, including a complicated incremental approach. But each time that you tried to provide more fairness, you added layers of complexity to it. We have just completely revised DISC and now have a FSC, a foreign sales corporation.

Now I'm not commenting on whether DISC or FSC is good or bad tax policy, but it is a benefit for the business community that Congress believed was appropriate in 1971. Over the years, you have modified or cut back DISC in some respects. Each one of those cutbacks has added complexity. And while I was on the staff, the business community did not favor those cutbacks to go on the incremental approach because something was taken away.

But the basic concept of a DISC added an additional complexity—more lines, more bookkeeping, more recordkeeping—but it was promoting an objective, an economic objective that the Congress thought was appropriate. Every time that the Congress has reviewed it since 1971, Congress has believed that it was appropriate to continue.

Once again, I'm not objecting to DISC, but pointing out that the legislation has provided a desired objective that Congress thought was appropriate.

Senator LONG. Well, thank you very much for your testimony. I'm going to take this little booklet that you provided home and study it because it deserves it. And I look forward to working with you when we have the opportunity to do more about the kind of things you are recommending here.

Thank you very much.

Mr. SHAPIRO. Thank you.

Mr. DILDINE. Thank you, Senator.

Mr. SHAPIRO. I certainly enjoyed being back and look forward to working with you as well.

[Whereupon, at 12:18 p.m., the hearing was concluded.]

MAJOR TAX REFORM OPTIONS

THURSDAY, SEPTEMBER 20, 1984

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m. in room SD-215, Dirksen Senate Office Building, Hon. John Chafee presiding.

Present: Senators Chafee, Heinz, Symms, and Bradley.

Senator CHAFEE. Good morning. I want to welcome everyone here this morning. This is the fourth day of our hearings on tax reform. These are very important. We have had a host of excellent witnesses, and today we are also fortunate to have some additional fine witnesses.

We look forward to the testimony because obviously in the next year we are going to have to be dealing with these problems. The contributions of all the witnesses are going to be most helpful.

I notice that the Democratic Presidential candidate is setting forth his thoughts, and we are glad to hear those. I must say, I, myself, differ with his approach. I certainly differ with the approach suggested of a surtax on those who are already paying taxes. I think a surtax compounds the inequities that frequently exist, particularly in the corporate field. A surtax is not seen as broadening the base.

Perhaps we will have some further enlightenment on those proposals by the Democratic candidate for President.

The first witness we are delighted to welcome is the Honorable Jack Kemp, a Representative from the State of New York. Mr. Kemp, won't you come forward. And let us say we are always anxious to hear your thoughts, which have been eloquently expressed on many occasions, and have certainly contributed to the dialog in connection with taxes and tax reform.

Mr. KEMP. Thank you, Mr. Chairman.

Senator CHAFEE. If you have anybody with you you want to bring forward, would you?

And with you also from the State of Hawaii is the Honorable Cecil Heftel. Why don't you also come up and sit down, and we will take both of you gentlemen, one after the other.

Why don't we start with Mr. Kemp.

Jack, glad to see you.

STATEMENT OF HON. JACK KEMP, A U.S. REPRESENTATIVE FROM THE STATE OF NEW YORK

Mr. **Kemp**. Mr. Chairman, thank you for allowing us to come over to this august body and discuss one of the two most important economic issues in America today: tax reform, simplification, fairness, and rate reduction. The other, of course, is monetary policy. I know this is not a hearing on monetary policy, but I consider that to be an extremely important subject, because it can have a great impact on our fiscal policy. In any case, I appreciate, Mr. Chairman, your willingness and that of the committee chairman, Senator Dole, to have these hearings to allow for a discussion of this incredibly important topic, its impact upon the American taxpayer, and on the American economy.

I have written testimony that I will not read in toto, but I would like to enter it into the record, discuss some aspects of it, and then respond to whatever questions you might have.

Senator **Chafee**. Fine. We will put it in the record and you just proceed.

Mr. **Kemp**. Thank you.

[The prepared written statement of Mr. Kemp follows:]

TESTIMONY OF CONGRESSMAN JACK KEMP ON TAX REFORM BEFORE THE SENATE FINANCE COMMITTEE

Washington, ~~D.C.~~, September 20, 1984

Mr. Chairman, I appreciate this chance to testify before the Senate Finance Committee on the subject of comprehensive tax reform. The pressure is growing for a comprehensive reform of our antiquated tax code, to reduce the complexity, increase its fairness, and provide more incentives for work, saving, investment, and economic growth.

As you know, Mr. Chairman, Senator Bob Kasten and I, together with many colleagues in the House and Senate, have introduced the "Fair and Simple Tax" (FAST) -- a plan to broaden the tax base and lower the tax rates, with special protections for the poor, homeowners, wage-earners, families, and senior citizens. We think it's a very good bill. However, my goal today is not to try to sell you on Kemp-Kasten per se. There is nothing sacred about the names on a bill, or even about almost any single provision of a tax reform proposal.

I am firmly convinced, however, that when this committee has fully considered the alternatives -- including the alternative of doing nothing -- sheer economic and political reality will narrow the range of choice to something which very closely resembles Kemp-Kasten. My confidence has nothing to do with Jack Kemp's or Bob Kasten's persuasiveness; it depends only on your political realism and common sense. In my testimony today, I would like to try to outline what I consider the economic and political realities of the tax reform issue.

Literally dozens of tax reform plans have been introduced in Congress, and dozens more will be introduced before we are through. But the issue is not as bewildering as it may seem. Conceptually, there are three basic approaches to comprehensive tax reform --the "pure" flat income tax, the "pure" consumption-based tax, and a "hybrid" or "progressive flat tax." Despite their attractions, the first two are economically and politically unworkable. Only a modified or "progressive flat tax," such as Bradley-Gephardt or Kemp-Kasten, stands a good chance of both gaining widespread public approval and doing much economic good for our economy, and I think Kemp-Kasten has a definite edge in both respects.

THE "PURE" FLAT INCOME TAX

The purest flat income tax would simply tax everything that gives a person command over wealth, at the same flat tax rate. Every "loophole" would be closed, and every exclusion, deduction, credit or exemption would be eliminated. With such a tax base, a flat rate as low as 10% or 15% could be expected to raise the same amount of revenue as current law.

This approach has obvious intuitive appeal. But the pure flat income tax has one big economic problem and one big political problem.

The economic problem is that simply eliminating all "loopholes" does not result in an economically rational, or even a simple, tax system. To take one small example, one of the "loopholes" in current law allows a person to deduct alimony paid from taxable income. Removing this deduction would tax the same income twice -- once when earned, and again when received. This is only one of many examples. Under the comprehensive income tax, there can be double, triple, or quadruple taxation of income. For example, capital income could be taxed once as the profit of a corporation, again as dividends received by shareholders, once more in the form of capital gains, and yet again if the income is reinvested and the return taxed.

Also, to be consistent, such a tax system would have to tax "income" which is not even received in cash, such as the imputed value of the services of automobiles and owner-occupied homes, unrealized capital gains, or in-kind employer- or government-provided benefits. This would create considerable problems of measurement, fairness, and enforcement.

The political problem is that applying a single flat tax rate to such a tax base, assuming that it raised the same amount of revenue as current law, would shift the distribution of the tax burden from the top to the bottom. With a 15% tax rate, taxes might be cut by 70% at the highest incomes, and raised by one-third or more at the bottom. Preserving large personal exemptions and standard deductions would mitigate the problem for the lowest-income taxpayers. But since it would require a higher flat tax rate to be revenue-neutral, it would only shift the tax increase to the middle class. And the higher the tax rate, the worse are the economic distortions due to multiple taxation of the same income.

Moreover, since the pure comprehensive income tax approach would eliminate the deductions for home mortgage interest, charitable contributions, catastrophic medical expenses, IRAs and other pension arrangements, and even the personal exemption, the tax increases would disproportionately hit homeowners, givers to charity, the catastrophically ill, savers, families with children, and senior citizens.

THE "PURE" CONSUMPTION TAX

The pure consumption-based tax tries to solve one major problem with the comprehensive income tax -- the bias against saving. The bias against saving arises from the fact that a person must save out of after-tax income, and then the return on saving is taxed again. The result is to tilt the incentives toward consumption and away from taxable forms of saving.

The consumption based tax takes many forms, ranging from the Value-Added Tax to the consumed-income tax, but economically they are equivalent. In each case, a taxpayer is allowed to deduct either net saving or the return on that saving from his taxable income. In other words, the treatment of saving would resemble either individual retirement accounts (but without limits on annual contributions or penalties for early withdrawal), or else municipal tax-free bonds (taxpayers save out of after-tax income, but are not taxed on the interest). The two are economically equivalent.

It is interesting to note in passing that under a consumption-based tax, the treatment of homeownership would be very similar to current law. That is, people would save to buy a house out of after-tax income, but would not be taxed on the rent-equivalent value of living in the house. This should be noted by those who think that sound tax theory requires penalizing home ownership.

The trouble is that the consumption-based tax has even worse distributional problems than the comprehensive income tax. At the bottom of the income scale, roughly 90 percent of income comes from wages and salaries, while at the top of the income scale, between one-third and more than one-half of total income is investment income, which would be tax-deferred under a consumption tax. As a result, a flat-rate consumption tax would result in an even larger shift of the tax burden from the top downwards than a pure flat income tax.

It is true that a system of progressive tax rates could be applied to a consumption tax base, to prevent these shifts. But the marginal tax rates would have to be in the neighborhood of 40% -- almost as high as current law -- to do so. Also, the pure consumption-based tax would abolish the corporate income tax as we know it. The revenue would presumably have to be made up by increasing personal taxation.

The fairness of such a system would be debatable. For example, the approach would likely hurt families with children, because children are treated for tax purposes as "consumption goods" rather than "investments." For example, the cost of education is not tax-deductible, but the increased income due to that education is taxed. Moreover, elderly citizens who had saved for a lifetime out of after-tax income at high tax rates would now be taxed yet again for consuming these hard-earned savings.

This raises a final problem with the consumption-based tax: complexity. While it has a certain elegant simplicity in operation, the transition from current law to the new system would require a long (at least 10-15 years) and complicated process of transition. This would be necessary to minimize multiple taxation of the same income, or outright tax avoidance, in changing from one system to the other. Even so, 10 or 15 years would not be long enough to fully solve the problem in many cases, as with senior citizens. And how many taxpayers -- or members of Congress, for that matter -- will actively support a plan that won't take effect for 10 or 15 years?

THE MODIFIED OR "PROGRESSIVE" FLAT TAX

These economic and political realities lead us very quickly to the conclusion that a "pure" flat income tax or consumption-based tax is not workable. The only realistic alternative is an approach which tries to borrow some of the best features of each, while avoiding their pitfalls. This is what we have tried to do with Kemp-Kasten.

Overview. Kemp-Kasten is sometimes called a "progressive flat tax," because it combines a single flat tax rate on taxable income with a progressive tax base. It resembles the comprehensive income tax in repealing a majority of tax preferences. However, it retains important deductions for mortgage interest, real property taxes, charitable contributions, catastrophic medical expenses. It resembles the consumption-based tax, on the other hand, by retaining current-law treatment (or close to it) for IRAs and Keogh plans, general-obligation municipal bonds, private pension plans, Social Security, and homeownership.

Kemp-Kasten departs from both approaches, however, with its special provisions for workers, the poor, families with children, and senior citizens. These include a doubling of the personal exemption to $2,000 (including an extra $2,000 exemption for the elderly and the blind), increased zero bracket amounts, and a new exclusion for 20% of wage, salary, and self-employment income, up to about $40,000. This tax base, combined with a 25% tax rate on taxable income, prevents any shifting of the tax burden to the poor or the middle class. Tax indexing is retained, nd extended to new items such as the capital basis. This prevents shifting the tax burden to the poor and the middle class in future years.

Without being exhaustive, Mr. Chairman -- or exhausting -- I would like to point out some of the innovative features in Kemp-Kasten, which I think point in the direction of the kind of tax reform we need. Kemp-Kasten is unique among tax reform proposals in co-ordinating the income tax code with other federal programs in order to reduce economic disincentives. In particular, it addresses what I call "the Social Security trap," "the poverty trap," and "the retirment trap."

Ending the "Social Security trap" Federal taxes on wages consist of the income tax, which begins at 0% on the first dollar of income and progresses up to 50% without an upper income limit; and the Social Security payroll tax, which is a flat 7% each for employers and employees, beginning on the first dollar of earnings but stopping at a certain threshold ($39,300 in 1985: the threshold is indexed to increase with average wages and prices).

Because there is no co-ordination between the income and payroll taxes, two things happen under current law (and under every existing tax reform proposal except Kemp-Kasten): taxpayers can pay a significantly higher marginal tax rate below $40,000 than above $40,000; and there is a significantly higher combined marginal tax rate on wages than on savings income below $40,000.

Kemp-Kasten addresses both problems. Under Kemp-Kasten, taxpayers may exclude 20% of their employment income, up to the Social Security wage base. Above the wage base, this exclusion is phased out, so that taxpayers earning more than about $100,000 receive no exclusion on any of their wages.

This increases the threshold at which people start paying income tax. Above that point, the exclusion effectively lowers the marginal income tax rate from 25% to 20% up to the Social Security wage base, which offsets the payroll tax rate. Phasing out the exclusion slightly raises the effective marginal income tax rate to 28% above about $40,000, exactly where the Social Security tax falls to zero. The 28% effective marginal rate continues until the exclusion is completely phased out.

This has three results:

o There is a smooth, almost flat combined marginal federal tax rate.

o The combined marginal tax rate is almost exactly the same for both employment and savings income at all income levels.

o Together with the increased personal exemption and zero bracket amounts, the wage exclusion prevents any shift in the tax burden to middle and lower income taxpayers.

Reducing the poverty trap. Under current law, low-income people who want to work face very high effective marginal tax rates, because they must give up social welfare benefits and pay income and payroll taxes. These effective marginal tax rates can reach or exceed 100% in many cases, which means that people can actually lose after-tax income by working.

Kemp-Kasten reduces the poverty trap by increasing the income tax threshold, so that no person below the poverty level will ever pay federal income tax. Under current law, a family of four starts paying tax at less than $9,000, compared with the poverty level that will be more than $11,000 next year, according to the Joint Committee on Taxation. Under Kemp-Kasten, a family of four does not pay income tax on the first $14,375, or about 130% of the poverty level. A single taxpayer would not pay tax on the first $5,875 of income, compared with a poverty level of about $5,500. Aside from making working more attractive than welfare, about a million and a half low-income taxpayers would be removed from the tax rolls.

Ending the retirement trap. Senior citizens who choose to work past age 65 face what _Forbes_ magazine has called the "96% bracket" -- a combination of federal programs which can take away 96 cents or more for every additional dollar of earnings. This is due to a combination of three federal measures.

o The "retirement test" reduces Social Security benefits by 50 cents for every dollar earned above a threshold of less than $7,000 a year, effectively creating a 50% marginal tax rate.

o The "threshold method" of taxing Social Security benefits adds 50 cents of Social Security benefits to taxable income for every dollar of gross income above a certain threshold ($25,000 for single taxpayers, $32,000 for couples). This has the effect of increasing the federal income tax rate by one-half: if you are in the 30% tax bracket, it can raise your effective income tax rate to 45%. And since taxpayers must include tax-exempt interest in calculating the threshold, this is a "back door" method of taxing tax-exempt municipal bonds.

o The normal federal income and payroll tax rates must also be paid on such earnings.

Kemp-Kasten eliminates the "retirement trap" by phasing out the retirement test and altering the taxation of Social Security benefits. The retirmement test benefit reduction is reduced from 50 to 25 cents on a dollar immediately, with zero reduction in benefits after five years. Instead of the "threshold method" of taxing Social Security benefits, the first $7,000 of benefits ($10,500 for a joint return) is simply excluded from taxation. This combination reduces the "96% bracket" by 60 to 70 percentage points. It also ends the "back door" tax on tax-exempt bonds for senior citizens.

Comparison with Bradley-Gephardt. Kemp-Kasten is similar to Bradley-Gephardt in many respects. Both plans broaden the tax base; retain deductions for mortgage interest, real property tax, charitable contributions, and catastrophic medical expenses; retain the exclusion for IRA and Keogh plans; and lower the top tax rate considerably. On the business side, both plans repeal most tax preferences, including the investment tax credit, and lower the top corporate rate to 30%.

I like all these features of the Bradley-Gephardt plan. However, there are also significant differences. Bradley-Gephardt has three tax rates instead of one; it caps the value of deductions, including mortgage interest and the personal exemption, at only 14%; it holds the value of the personal exemption for dependent children at only $1,000, where it has been since 1978; it repeals indexing of the tax code, which would shift the tax burden over time to middle- and lower-income taxpayers, especially by eroding the value of the personal exemption and zero-bracket amounts; it raises the top capital gains tax rate by one-half, from 20% to 30%; and it generally has fewer incentives for saving and investment. These are concerns to me, but I think there is clearly room for dialogue among the sponsors of Kemp-Kasten and Bradley-Gephardt.

Further modifications of Kemp-Kasten. When Bob Kasten and I first introduced this bill (H.R. 5533) last April, I said: "My colleagues and I do not claim that this bill is the last word in tax policy. If we can find ways to improve upon it, we will. Rather it is a first word, a way to restart debate in Congress on proper tax policy."

We introduced a second version of the bill (H.R. 6165) in

August. Besides making technical improvements, the second version contains the modifications I have described which end the "retirement trap." And we are prepared to develop the bill further. For example, the 1984 revenue bill removed some of the tax preference items which would be repealed by both Kemp-Kasten and Bradley-Gephardt. This may require further modifications of Kemp-Kasten to meet our goal of revenue neutrality. We'll know more about that when the Joint Committee on Taxation completes estimates on our bill. We may also make other changes as new information becomes available, to meet our goals of simplicity, fairness, and increased incentives.

In conclusion, Mr. Chairman, while the range of tax reform proposals is theoretically infinite, when you look at the economic and political realities, the range of choices narrows quickly to a "modified" or "progressive" flat tax. In my unbiased opinion, Kemp-Kasten is the best of the existing proposals, and the co-sponsors plan to modify the bill as necessary to keep it that way. I look forward to working with this committee in any way I can, to bring about a simpler, fairer, family- and growth-oriented tax code.

Thank you.

Mr. KEMP. I would also like to say, Mr. Chairman, that I totally agree with you with regard to the candidate for President against Mr. Reagan, Mr. Mondale, who said recently that he would impose a surtax. I agree with your point. It would compound every inequity already in the Tax Code. A surtax on top of the steeply graduated income tax rates that we already have would be a tax on top of a tax and would distort or compound all of the inequities that already exist.

Having said that, the real issue in America is not raising tax rates or increasing the progressivity of the Tax Code. It is how we can bring about reform of the Tax Code to bring about the basic ingredients of a sound taxation system which will raise the necessary revenue, allow people to pay according to their ability to pay, and, of course, not discourage the industriousness of our people. Those were maxims of taxation laid down by Adam Smith over 200 years ago. They are as true today as they were then. And it seems to me that the debate now in America is not over the Mondale plan to raise rates—I think it's interesting, Mr. Chairman, that the debate really is about how low we should bring the rates.

There is the Bradley-Gephardt plan to bring the top tax rate to 30 percent, Kemp and Kasten would bring them to 25 percent, the Quayle plan would bring it to 19 percent. There are members of the House who want to go down to 10 percent. Senator DeConcini has introduced, I think, the Hall-Rabushka plan. I think it's a significant departure from an economic and political climate of which this country has, I hope seen the end. And those candidates who are talking about putting surtaxes on the existing income tax system are really at odds with the movement in the country philosophically and politically, and they are at odds with the latest thinking on how the economy could work if the tax system were more efficient. That is what I would like to discuss, Mr. Chairman.

As you know, Senator Kasten of Wisconsin and I have introduced what we call FAST, the fair and simple tax, a plan to broaden the tax base, and lower the tax rates, with special protections for the poor, for homeowners, wage earners, families, and senior citizens. Can you do it and still have revenue neutrality? I think you can, Mr. Chairman.

We think it's a good bill. It's not the last word. It's only the first word. And as I said before, I have great respect for those Members of the Congress on both sides of Capitol Hill who have introduced tax reform measures and are contributing to this debate over how to encourage working, saving, investing, producing, entrepreneurial activity. And that's a healthy debate for America, Mr. Chairman, and I look forward to participating as the days and months go on.

But my goal today is not to sell anyone on Kemp-Kasten per se, Mr. Chairman. There is nothing sacred about any name on a bill or even about almost any single provision of a tax reform proposal. This debate will go on for a number of months, and it's a healthy one. And I'm sure there will be some changes on both sides before we finally decide on tax reform.

I am convinced, however, that when this committee has fully considered the alternatives—including the alternative of doing nothing, which I think is abominable—sheer economic and political reality will narrow the range of choice to something which closely resembles Kemp-Kasten, or something like what Mr. Bradley and Mr. Gephardt are talking about.

I have said publicly that if it came to a vote today, either one would be better than what we have. My confidence in tax reform has nothing to do with Jack Kemp's or Bob Kasten's persuasiveness. It depends only on political realism and common sense.

In my testimony today I would like to outline what I consider the economic and political realities of this tax reform issue.

As I said, literally dozens of tax reform plans have been introduced in Congress. Dozens more will be introduced before we are through. But the issue is not as bewildering as it may seem.

Conceptually, there are three basic approaches to tax reform. There is a pure flat tax. There is a pure consumption based tax. And then there is a modification or a hybrid or what you could actually call a progressive flat tax. I used to laugh at that term because I thought it was inconsistent. But I don't think it is, because there are ways to maintain progressivity on the tax code with flatter tax rates.

Despite their attractions, I don't think the first two—that is a pure flat tax or a consumption tax—are economically or politically workable. Only some modified or progressive flat tax, such as Bradley-Gephardt or Kemp-Kasten, stands a good chance of both gaining widespread public approval and doing economic good. And speaking with perfect objectivity, I think Kemp-Kasten has an edge.

The pure flat tax would simply tax everything that gives a person any command over wealth, at the same flat rate tax. Every loophole would be closed. Every exclusion, deduction, credit or exemption would be eliminated. A flat tax as low as 10 or 15 percent could probably be expected to raise about the same amount of revenue as current law. And it has some intuitive appeal. But the pure flat income tax has one big economic problem and one big political program. The economic problem, Mr. Chairman, is that simply eliminating every loophole does not result necessarily in an economically rational or even a simple tax system. To take one small example, one of the loopholes in current law allows a person to deduct alimony paid from taxable income. Removing the deduction would tax the same income twice, once when earned and again when received. This is only one example.

Senator CHAFEE. When received by the spouse?

Mr. KEMP. Yes. And under the comprehensive income tax, there can literally be double, triple or quadruple taxation of income.

And there is the political problem. Applying a single flat tax rate to such a tax base, assuming that it raises the same amount of revenue as current law, would shift the distribution of the tax burden from the top to the bottom. With a 15-percent tax rate, taxes would be cut 70 percent at the highest income and raised by one-third at the bottom. Preserving large personal exemptions or standard deductions would mitigate the problem for the lowest income taxpayers. But since it would require a higher flat tax rate to be revenue neutral, it would only shift the tax increase to middle-income Americans. And the higher the tax rate, of course, the worse the economic distortions become.

A pure consumption based tax, Mr. Chairman, tries to solve one of the major problems with a comprehensive income tax. That is the bias in our Tax Code against savings.

A consumption based tax takes many forms. I won't go into it in great detail, but it ranges from a value added tax to a consumed income tax.

Economically they are equivalent. In each case, a taxpayer is allowed to deduct either net savings or the return on that savings from his or her taxable income.

In other words, the treatment of savings would resemble either individual retirement accounts or else municipal tax free bonds; as I say, the two are economically equivalent.

The trouble is that the consumption based tax has an even worse distributional problem than a comprehensive income tax. At the bottom of the income scale, 90 percent of income comes from wages and salaries, while at the top of the income scale, Mr. Chairman, between one-third and one-half of total income is investment income, which would be taxed deferred under a consumption tax. As a result, a flat rate consumption tax would result in an even larger shift of the tax burden from the top downwards than a pure flat income tax.

It's true that a system of progressive tax rates could be applied to a consumption tax base to prevent these shifts. But as I understand it, the top marginal tax rate would have to be near 40 percent to get the same amount of revenue as current law. And that would be a disincentive to production because I represent steel workers and auto workers, Mr. Chairman, and I can assure you that they are working to earn income so they can consume. They have to consume. Families have to consume. And I think it would be devastating to them to have a tax system based only upon consumption, whether it is added on top of our income tax as a value added tax would be, or a progressive consumption tax, such as we are discussing.

I won't discuss the complexity of a consumption based tax as I am not really here to speak against things as much as I am to speak for something better.

I would like to turn my attention, Mr. Chairman, to a modified or what I called earlier a progressive flat tax. I think the economic and political realities lead us quickly to the conclusion, Mr. Chairman, that a pure flat income tax or a consumption based tax is not workable in this climate. The only realistic alternative, as I said, is something like what we are talking about with Kemp-Kasten or even Bradley-Gephardt or something in between.

Kemp-Kasten is sometimes called a progressive flat tax because it combines a single flat tax rate on taxable income with a progressive tax base. On the one hand it resembles a comprehensive income tax in repealing most of the tax preferences. However, it retains important deductions for mortgage interest, real property taxes, charitable contributions, major medical expenses. It resembles the consumption based tax, on the other hand, by retaining current law treatment or close to it for IRA's, Keoghs, general-obligation municipal bonds, private pension plans, Social Security, home ownership, et cetera.

Kemp-Kasten departs from both approaches, however, with its special provision for workers—the poor, families with children, senior citizens. These include a doubling of the personal exemption to $2,000.

Mr. Chairman, at this point I would like to depart from my prepared remarks long enough to suggest that if anybody looked at the personal exemption and what it was in 1948—$600—and if you had indexed it for inflation, it would be over $2,500 today. If you had indexed it as a percentage of the income it represented to the average family in America in 1946, it would be close to $6,000 today.

That shows you what has happened to the ability of families to keep after-tax income. And we know what has happened to families, who have often had to have two working partners in order to maintain a standard of living which used to be possible with one income. It has had devastating consequences both economically and socially. I think something has to be done. We double the personal exemption to $2,000, and then index it.

We increase the zero bracket amount. And we put in a 20-percent exclusion for income from wages, salaries, and self-employment income up to about $40,000 and then phase it out.

My feeling, Mr. Chairman, is that one of the other most devastating consequences of the U.S. Tax Code is the impact that our tax system has on the working poor or a welfare family that wants to increase its income by working in the private sector.

Arthur Laffer has pointed out that in Los Angeles County a mother of three children, family of four, who is getting $8,000 of transfer payments for housing and medical and food allowances, which are nontaxable sources of income, must earn between $16,000 and $19,000 a year before taxes and after giving up transfer payments in order to match the after-tax income given to her by transfer payments. If you took a job, you would have to earn that much money. In other words, our system creats tremendous disincentives to taking a job, besides the fact that the economy has not been effective enough in the inner city in creating those jobs.

Kemp-Kasten would abolish the Federal income tax for any income below $14,375 of a typical family of four. That would provide an incentive, and take the working poor and the low income poor off of the tax rolls until they get onto the economic ladder and can start to climb upward and provide the mobility for their families that has historically been part of the American dream.

Our tax base, combined with a 25-percent tax rate on taxable income, Mr. Chairman, prevents any shifting of the tax burden to the poor or to the middle class, which is the main argument against a flat tax. Mr. Bradley and Mr. Gephardt have a different way of doing it. They have a less progressive tax base and more progressive tax rates. This is something open for discussion. But it's interesting that the two major proposals recognize that a pure flat tax would raise the bottom rates and lower the top rates, and I don't think that's either fair, good for the economy or politically possible.

We retain indexing. I personally believe that indexing is a very important part of the Tax Code. It was part of Kemp-Roth in the beginning. I would like to see us index capital gains. I don't think we ought to raise capital gains rates. I think they should be indexed.

Our Kemp-Kasten bill was unique among tax reform proposals in coordinating the Income Tax Code with other Federal programs in order to reduce economic disincentives. To mention only one example, we end the "Social Security trap." I won't go into it in great detail, Mr. Chairman, but you know that Federal taxes on wages consists of the income tax, which begins at zero on the first dollar of income and progresses up to 50 percent without any upper income limit; and the Social Security payroll tax, which is a flat 7 percent each for employers and employees beginning on the first dollar of earnings but stopping at a threshold of about $39,000 in 1985—there is no coordination between the income and the payroll tax.

While my time is running short, if it is all right with you, Mr. Chairman, I would just like to finish this point.

Two things are happening under current law. And basically they would happen under every existing tax reform proposal except the Kemp-Kasten bill. A taxpayer can pay a significantly higher continued marginal tax rate below $40,000 than above $40,000 and there is a significantly higher combined marginal tax rate on wages than on savings income below $40,000. The payroll tax is beginning to be an impediment to earning more income for senior citizens. It is also an impediment to workers. And it's also an impediment to small businessmen and women who want to hire people and have to face this huge tax wedge that falls on hiring a new worker.

We address these problems under Kemp-Kasten, by excluding 20 percent of employment income up to Social Security wage base, and above the wage base this exclusion is phased out.

This increases the threshold at which people start paying income tax. Above that point, Mr. Chairman, the exclusion effectively lowers the marginal income tax rate from 25 to 20 percent, up to the Social Security wage base, which offsets the payroll tax rate.

And it has three results. It's a smooth, almost flat combined marginal Federal tax rate. The combined marginal tax rate is almost exactly the same for both employment and savings income at all income levels. And together with the increased personal exemption and the zero bracket amount, the wage exclusion prevents any shift in the tax burden to middle and lower income taxpayers.

I want to stop at that point because our time is running short. I would just like to make one last point Mr. Chairman, and say that I am convinced that whatever happens, we can broaden the tax base and bring down the underground economy, Mr. Chairman, by making the Tax Code more efficient. I don't want to get into a static or a dynamic debate here today about models and how wrong they have been in the past. I see that the New York Times yesterday pointed out something that supply-siders claimed a long time ago. We apparently made one mistake: Only the rich are paying higher taxes today! Well, we really apologize for that, but many of us predicted that if we brought down the rates and removed the disincentive that high marginal tax rates placed on investment income, we would get more investment and get more revenue at the same time. And while the New York Times takes a pejorative interpretation of this, it's quite obvious that even their own article recognizes that the top 1 percent of all taxpayers are now paying significantly higher revenues into the Federal Treasury.

I have made some comments about the Bradley-Gephardt bill. I see the author is here. I want him to know that I respect what he has done. I think that if there was an effort made in 1985, I would be glad to join with Mr. Gephardt and Mr. Bradley in moving forward on the type of tax reform that can lower the rates, broaden the tax base, remove the inequities, and make the Tax Code fairer, and simpler. And you know what? It leaves you pretty close to what President Reagan wants to do in 1985. So I think we have got a chance.

Thank you, Mr. Chairman.

Senator **Chafee**. Well, thank you, Congressman Kemp.

I tell you what. Congressman Heftel is here, and why don't we hear his comments and then we will ask some questions of both of you. How is your time situation?

Mr. **Kemp**. I'm sorry to say I have another meeting immediately. I was under the impression that I would be able to give my testimony and then be able to depart.

Senator **Chafee**. All right.

Mr. **Kemp**. If there are no questions, I would be glad to leave at this point.

Senator **Chafee**. I do have a question. I think what you have come up with and your statements are excellent. The trouble is: What about the revenue? Where are we going to stand when we are all through here? If we double the personal exemption, if we do everything you have talked about, taken care of the Social Security trap, and deal with the poverty trap, and all the rest of these retirement traps, and we have worked our way through that mine field, where do we stand? Where is the revenue?

Mr. **Kemp**. The Joint Tax Committee in its estimate, and I recognize that like all static models it has been off in the past, but the Joint Tax Committee says, based on 1981 income levels, that it would be revenue neutral, and about the same for estimated 1985 income levels. And, again, they are looking at it from a very static standpoint. I think every tax bill we discuss is going to end up being debated on what impact it will have on revenues and the tax base.

But it's clear to me, Mr. Chairman, that based upon the 1981 tax rate reductions, particularly on personal income, it's clear that the type of comprehensive review and reform of our Tax Code along the line we are talking about would broaden the base, bring down the underground economy and allow us to do some things for the working poor and the senior citizens and inner-city trapped people on welfare that has not heretofore been done.

And if you look at the world, Mr. Chairman, all over the world this same problem exists. I mean France has been trapped by a tax system that is losing revenue. When Francois Mitterand came into power, he raised tax rates. He found all he did was chase capital out of France, cause the stock market to collapse, and now France is talking about cutting tax rates. Margaret Thatcher faces the same problem. Now they are talking about reducing their tax rates. I see that people are talking about Israel's problems and what they can do to get austerity into Israel. And the U.S. State Department, unfortunately, is talking about raising taxes in Israel. Do you really think you can get any more revenue from people who right now have the highest underground economy in the world?

I think our underground economy, Mr. Chairman, is a direct response, direct manifestation of the fact that our Tax Code is an abomination. It is Byzantine. It is unfair. It is not simple. And it destroys the incentives not only for capital, but the point I am making is that it also erodes the incentives for the poor and for workers as well.

Senator **Chafee**. You are not in favor of it? [Laughter.]

Mr. **Kemp**. There is only one person that I have found that is in favor of it, Mr. Mondale, and he wants to put a surtax on top of it all.

Senator **Chafee**. I notice one of the more dramatic changes you would make is that you would eliminate the special treatment of capital gains. And they would be treated as ordinary income. Am I correct?

Mr. **Kemp**. Well, over 10 years it would be phased in. And then, of course, during those 10 years the top rate would be 20 percent. And while capital gains would ultimately be treated as ordinary income, which most tax proposals require, we would index the basis for inflation and we would remove the holding period.

Senator **Chafee**. Well, we certainly appreciate your views. And I have no further questions. I will say that you are talking to someone who is extremely unenthusiastic about all indexing.

Mr. **Kemp**. You are, Mr. Chairman.

Senator **Chafee**. I am. We could discuss this to some length, so we won't bother doing it here.

Mr. **Kemp**. I can understand why the chairman might not want to discuss it. I thought that was pretty much——

Senator **Chafee**. But it's interesting that you should bring up Israel where they have got the ultimate of indexing and its chaos. But that's not the point here.

Senator Bradley.

Senator **Bradley**. Thank you, Mr. Chairman, first of all let me thank Congressman Kemp for his testimony and for his work. I was very pleased to hear him say that he looked forward to working in a bipartisan way to get tax rates down and to eliminate many of the existing tax expenditures. I was also pleased to hear him point out what the problems are with the other two directions that the Congress might take in tax policy. One, simply raising rates on the present system, and the other some form of consumption tax.

And I wondered if he might not want to contrast once again for the committee the differences he sees between a system that moves in the direction as both the bills that he and I and Gephardt and Kasten have introduced, lower rates and fewer loopholes and one that simply moves in the direction of taxing consumption, and why he might feel that one was fairer than the other.

Mr. **Kemp**. Well, I would just say without reiterating my testimony that I think the biggest danger with the two other approaches is that we would shift the burden of taxation dramatically downward.

And I accept the idea that people should pay taxes according to their ability to pay. That is a legitimate function of a tax system. It is again predicated upon my free enterprise beliefs that came out of the classical views of Smith & Say and others.

As far as I am concerned, the best way to tax wealth is to get the rate set at a level of equilibrium at which wealthy Americans are willing to invest at the highest level and be as productive as they can be in producing jobs and enterprise and still pay their share of taxes.

And on that basis, I think lowering the marginal tax rates on all income, is better than taxing only consumption because consumption is the reward for production. Punishing consumption would be a serious disincentive to industriousness, especially among lower income people who have to consume a larger share of their income.

Just another point. A married couple with children would suffer a terrible disincentive relative to a single man or woman earning the same income, because they have to consume more in raising the kids. And I don't think the Tax Code should be biased against marriage and families. Children should not be taxed as consumer durables.

Senator BRADLEY. So the last point was the point that I had hoped you would make, which is that any consumption tax is really hard on families.

Mr. KEMP. On the family, absolutely. That's why I think the personal exemption should be raised. I can't pass up the opportunity to say that Israel's problem is not the indexing of the Tax Code, Mr. Chairman. Their problem is that they indexed the cost of living to every single aspect of wages and salaries and savings.

Senator CHAFEE. I tell you what, if we get into Israel's problems here today, we will be here a long time.

Mr. KEMP. I didn't raise it.

Senator BRADLEY. Mr. Chairman, let me just say that I appreciate the testimony and thank the Congressman for his work on this and his willingness to look for real action in 1985 on a bipartisan basis.

Mr. KEMP. Thank you.

Senator CHAFEE. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman. And without prolonging your big agenda you have here this morning, I just want Congressman Kemp to know that I'm extremely enthusiastic about indexing the Tax Code so that balances it up here. So he should feel good to know that.

Senator CHAFEE. Well, he can feel even better since I presented a proposal to postpone indexing for 3 years, and I think I received about six votes, if that many, out of this 18-person committee.

Mr. KEMP. Good sign, Mr. Chairman.

Senator CHAFEE. It shows that the correct decision doesn't always prevail. [Laughter.]

Senator SYMMS. I do just have two quick questions. One is that I get very skeptical about making any changes in the Tax Code, but that I felt that the 1981 Tax Act was a massive step in the right direction. In retrospect, looking back, in the history of the last 2 years and the other things that have been done to the Tax Code, it seems to me like even maybe in the case of your bill, which I'm glad you have introduced because it does lead in the direction that I think is a good way to go, although personally I would favor raising the exemption much more and going more to a tax like the Hall-Rabushka, but it's probably not politically feasible, and you may be correct in that—but you and Senator Bradley, both, I think are pointing in a direction that's good leadership.

But how about just not changing anything in our present Tax Code except just simply pass a law that said we will lower the rates across-the-board 5 percent a year for the next 5 years? And if there is a problem about progressivity, increase the personal exemption on the bottom end, a couple hundred dollars a year or something to make up the difference, or $500 or whatever it would take. And just do it that way. And then not allow anybody to touch anything else in the Tax Code so you don't have this constant turmoil and chaos out there.

Mr. KEMP. Well, the Kemp-Roth bill originally introduced in 1977 was a 30-percent across-the-board reduction in tax rates. We took that approach. It took moving heaven and Earth to get even the 25-percent reduction from 1981 until 1984. In January 1984 we finally implemented the tax reform that began in 1978. And again, it was very difficult to do, though it was done. We also lowered the double tax on dividends and the tax rates on capital gains and removed the inequity between earned and unearned income. So from that standpoint, I think the next move intellectually and politically is to move to tax reform. If you just cut everybody's rate by 5 percent, I think you would find that all the econometric models in this town are still based upon the idea that statically there would be such a huge revenue loss in one sector of your taxpaying constituency that Congress, I don't think, would do it again, Steve.

And I, frankly, think the country has cried out for simplification and reform combined with lower rates and some protection for the people alluded to in our testimony. I would be glad to lower the top rates again.

I think one of the biggest mistakes we made was not lowering the 50-percent rate on salary income. We lowered the 70-percent rate to 50 percent. We lowered the other rates by 25 percent. We did not lower the 50-percent tax rate on earned income. And that was, I think, a serious error.

Senator SYMMS. Well, one other question. If we are going to go this route—and let's say for example you could have your druthers and the Congress came in next year after a massive victory this fall by the President and he got behind something close to this, and we were able to mount the support, pass it through the Congress—do you think we should go one step further and apply a negative income tax to this so this lady in Los Angeles that Arthur Laffer is talking about would have an incentive to try to work as much as she could, and be part of the system?

Mr. KEMP. By negative income tax, do you mean a refundable or——

Senator SYMMS. Some way that if they don't have enough income that you send them back the money.

Mr. KEMP. You have got to change our welfare laws, which literally take away all welfare benefits as people earn income, and then we tax their income at the State and local level and the payroll tax all combined to make it a huge disincentive. I would not take away as much of the welfare until they have earned enough income to give that mother or father a reward for going into the private economy. So I think something has to be done.

I would just conclude, Mr. Chairman, by suggesting in answer to this question that whatever happens in 1985, I think it's part of the national debate now and that's healthy. It's part of the Presidential debate because you have one candidate calling for surtaxes and taking up indexing, and then you have the other candidate talking about reform and broadening the base. I would just hope we would leave four or five key principles. I hope we leave indexing. I think that's incredibly important. I know I disagree here with the chairman.

Second, I don't think we ought to raise the tax on capital gains, Mr. Chairman. I think raising the capital gains tax would be a mistake. Third, I don't think we ought to go back to the pre-1981 Tax Code on depreciation schedules. I think the ACRS is flawed, but is better than what we had before 1981. And I think we definitely need to do something both for the working poor and for the families to get their income levels up so they can begin to get the cohesiveness that comes with more access to income at the family level.

So with that, Mr. Chairman, I just applaud your efforts. Thank you for stimulating the debate, and I appreciate the work of my colleagues.

Senator **Chafee**. Thank you very much, Congressman.

Now we welcome Congressman Heftel. We are delighted to see you looking so fit and back once again. And you are a living testimony to the recuperative powers of your native State.

Mr. **Heftel**. Thank you, Mr. Chairman.

STATEMENT OF HON. CECIL HEFTEL, U.S. REPRESENTATIVE, STATE OF HAWAII

Mr. **Heftel**. It's interesting to note that I came to the Congress 8 years ago, and before I was elected I started talking about tax reform as something that I thought had come of age, and that I would go to the Congress and find ourselves all concerned with it. I'm happy to say that at least 8 years later we have started the dialog and I applaud what you are doing today, and what all the Members of the Congress are doing who are trying to focus on the need for tax reform.

But as I listened to Mr. Kemp, I couldn't help but think of the fact that I evolved what at that time was called by me a consumption tax while in the hospital in Long Beach, CA. And I didn't think that by the time we got to discussing it some 1 year and 3 months later that we would have moved to the point that a national sales tax, a value added tax, and a progressive consumption tax would have all come under a single umbrella—a word "consumption," which is basically a red flag and regressive to the public in nature.

And so we have already learned that we can't call it a progressive consumption tax because if we do, we will be lost before we start because the people will hear the word "consumption," and assume what we are talking about a regressive tax, like a national sales tax or a value-added tax, and, therefore, we are using a term which we didn't develop but came out of Brookings, I'm happy to say, which is a cash-flow income tax. Because we have got to distinguish between a consumption tax as it relates to a sales tax and a value added tax and the type of cash-flow tax that I will be talking with you this morning about.

And I think that it's important to make the distinction because otherwise we won't get any constructive dialog about the concept of a cash-flow income tax. And it isn't something I'm necessarily wed to. It isn't something I'm trying to sell in competition with anything else. I'm only trying to get it out on the table so that before we get through with whatever occurs in the process of reforming the Tax Code, that we consider all constructive possibilities and do it constructively.

I was somewhat amazed to hear my colleague from New York tell us that we would be doing this for months. We won't be doing this for months. We will be doing this for years. And if we try to do it in months, we will end up with a nightmare. I think also before we get into the substance of what we are talking about, we have to make other observations.

First and foremost, the Tax Code isn't as inequitable as we are constantly told. If you take a look at the fringe benefits of 16 to 20 or 25 percent for 50 or 60 percent of the working people of America, we begin to realize that the so-called exemptions and exclusions and loopholes, however you want to describe them, are now very broad based. And that everybody has learned about how to get their percentage out of the system in some way so that there is an equality of inequality now starting to take place.

And I mention it because the idea that we are totally distorting the system in favor of the few against the many is no longer true.

I think there is another aspect that we have to focus on. Most people don't want to talk about the deficits because they haven't got the slightest idea what to do about them. And so they have come up with a new gimmick for political people who want to talk about something that camouflages the deficit, and that's tax reform. Somehow you tell the people that tax reform solves the problem of deficits.

Now that occurred successfully once in 1979 and 1980. As you may recall, the present tax system we were told would result in a balanced budget. I don't think we have to argue whether or not it balanced the budget.

What we are now being told is forget that experience. Pretend it never happened, and believe us with the very same story again. Namely, this magic word we formed will take care of all the problems of deficits, which is not true. It won't.

All we are talking about in reform is improving the way people pay about the same amount of taxes. Most people under any of the reform proposals on the table will find that they end up paying about the same amount of taxes. There isn't going to be any dramatic change. And if we are going to balance the budget, we are not going to do it unless we do something that hasn't occurred yet, which is either increase taxes or decrease expenses. There isn't any magic formula for balancing the budget. And I think it would be unfair if we tried to deceive the American people into thinking that somehow under the cloak of reform of tax, we are going to solve the problems of deficits because we are not.

Now having said those things, we still ought to look at a reform of the system. And I applaud what Senator Bradley has done, and my colleague, Dick Gephardt, and all the others who have looked at the system and tried to improve upon on it in something that people can feel more comfortable with.

As far as the system that I have proposed—and I think I have already run out my 5 minutes, which is interesting in what you can do when you don't use a script—but in any event—that's why we have a 5-minute rule in the House, I guess—but in any event, I think that the cash-flow income tax concept has merit.

I will ask you to place my full statement in the record, and very briefly summarize. And if you want me to, go through the essential elements if you have the additional time.

But there is no question that capital formation ought to be what we are looking at first and foremost in what we do when we address the Tax Code. It has been suggested that the cash-flow concept I am discussing with you is regressive and unfair to the poorer people because they can't save. I think that's an atrocious statement to make. I can remember when I didn't have enough to eat, but I still knew I needed to save because I wanted to go to college.

The concept that you deny to people the aspirations to save because of where they start in the economic ladder is outrageous, and I can't believe I heard the statement made by the gentleman who wants to be President in 1988. He is going to have to learn that all people aspire to save, and that poor people usually are the ones who end up saving the most because they have the most sense of value for having a dollar of protection.

But I don't think that a cash-flow system of income tax in which we address people's attention to the concept of saving is in the least unfair to people at the lower end of the spectrum. And in my proposal, we have a $12,000 exemption for a family of four so they don't pay taxes until they go over $12,000. If we want to make it higher than that, it's easy. All you have to do is say you don't need the revenue, and you can go as high as you want, of course.

But we can do whatever we want to whether we use the present system or we use the cash-flow system that I am discussing with you today. The essential merit of the cash-flow system is that it makes people look at the virtue of savings. It makes them look at the fact that interest is no longer something Uncle Sam pays for. That interest is expensive. That 19 and 20, 22, 24 percent interest and whatever they can get away with on those credit cards is an atrocious dissipation of the people's money.

And so the thing we are trying to create through the income tax under the cash-flow concept is an awareness on the part of people that interest can be a great dissipation of their money. And if you don't have a system that encourages interest expenditures because you write it off, will get a better potential for savings, for reduction of credit, and hopefully reduction of interest rates—now that is essentially what we are trying to achieve. Money for capital formation. Savings on the part of the American people as a whole.

Our main allies with whom we compete have much greater rates of savings. The Japanese are going well over 20 percent where we are struggling to get over 6 percent.

Senator **Chafee**. I wonder if you could give the major features of your program.

Mr. **Heftel**. If you want me to take the time to do so, I will.

Senator **Chafee**. In just a few minutes, touch on it, if you could.

Mr. **Heftel**. The taxation of cash-flow provides the best incentive for savings and investment. Under the cash-flow income tax system, all income is taxed once, either at the time of consumption or at the time of death in a state tax forum. Cash-flow tax can be deferred as long as one's lifetime, providing the stimulus for capital formation. The formation of capital will result in positive long-term economic growth.

In the bill, annual cash flow is derived by calculating the value of his or her total receipts in the year using the W-2 and 1099 forms presently used. From that value is subtracted the amount of net savings and investment made by the taxpayers during the year. The difference between what was received and what was saved over the year is cash-flow, the tax base.

Senator **Chafee**. Would all income count toward this formula?

Mr. **Heftel**. Yes.

Senator **Chafee**. For example, unemployment compensation.

Mr. **Heftel**. Anything that is of value is part of your compensation. There is no such thing as a fringe benefit. Everything is equal with everything else that you receive.

Senator **Chafee**. How about the value of health care provided by a corporate employer?

Mr. **Heftel**. There is a 5-percent margin for health costs, which would include the cost of premiums paid for the employee. But other than that, everything is counted.

Senator **Chafee**. Well, how about premiums said for life insurance by a corporate employer?

Mr. **Heftel**. That would be a form of compensation. We admit the compensation is compensation. We call a spade a spade.

Senator **Chafee**. Take the difference between all your income and what you save.

Mr. **Heftel**. Yes.

Senator **Chafee**. If you buy life insurance, is that a saving?

Mr. **Heftel**. It could depend on the nature of the policy. But much insurance would come under the savings or investment umbrella. Yes.

Senator **Chafee**. All right. So you deduct that.

Mr. **Heftel**. Let's put it this way. A term policy, one year on your life would not be a savings that qualified under this proposal. But any kind of a policy that develops any equity, any cash value, would be a savings and would come under this umbrella.

Senator **Chafee**. So let's say you have got $30,000 of income and you put $5,000 in various forms of savings. An IRA, I suppose that's a savings.

Mr. **Heftel**. Oh, of course.

Senator **Chafee**. Then you get $30,000, you save $5,000 so you are at $25,000. That's your starting point.

Mr. **Heftel**. Correct. And you have a $12,000 exemption for a family of four so your tax would now be—the base would start at $13,000. Then you have to deduct from that $13,000 the things that we provide exclusions for. Your primary residence, State, and local taxes, casualty losses for which you don't have insurance, medical costs above a certain threshold. Those would be exceptions that would be taken out of the $13,000 remaining, and let's say if you have $3,000 of exceptions that were included in this provision, you then would be taxed on $10,000 at the applicable rate, which would start out at 10 percent. Then it goes to 23 and then goes to 30. You only have three rates; 10, 23, and 30 percent.

Senator **Chafee**. Any other points you want to make?

Mr. **Heftel**. No; I think that covers the main elements that I wanted to share with you and the hope that somehow we won't look upon a cash-flow income tax as a consumption tax or as a tax which discriminates against the people who are less affluent. It doesn't do either of those things. It merits concern and our attention ought to be one of the ways that we consider revising the system if we do. And in whatever we do, we ought to start on the basis that maintaining the economic recovery and trying to inspire greater amounts of capital for investment should be our two main objectives in the process of achieving more fairness in the tax system.

And I don't think you can just summarily dismiss whatever is in the Code now that inspires investment or ignore the fact that we have a fragile recovery which could be harmed by any ill conceived tax increases at this time.

Senator **Chafee**. Thank you.

Senator **Symms**. Thank you, Mr. Chairman, and thank you, Congressman Heftel. And, Mr. Chairman, you may not know, but he used to have a radio station in my State. And I'm delighted to see you feeling well and here before us. And as always, Cec, you certainly lay it on the line. And I would just like to ask you how many cosponsors do you have on this proposal?

Mr. **Heftel**. I haven't even tried to get cosponsors at this juncture. When I orginally did it, I was in California. And until I redraft, I won't try to get cosponsors.

Senator **Symms**. Well, I would say one thing about it. If it's a good idea, it only needs one sponsor anyway. And, obviously, I think you have given us a lot of thought and I think it's very interesting. It goes more in a direction that I would like to see us go with the Tax Code if we are going to do something dramatic and simplify it. Most of the propositions that I have heard of, I would like to look into a little more carefully.

And I want to encourage you to keep working at it. And I would like to at least let you know that I am interested in what your proposition is. And encourage you to keep working at it.

Did you get some of these ideas originally from the Institute or is this an idea that you have had for a long time?

Mr. **Heftel**. Had the idea for a long time, Steve. And with nothing to do in a hospital in Long Beach, CA, but think about this type of process, it was easy to decide to develop some kind of a legislative proposal. And then suddenly we had consumption taxes confusing the issue, and then we had people seriously pursuing the subject. And now we are trying to conform it.

For instance, I started out using a different percentage scale to address the deficit problem. I concluded that that was the wrong way to go so we now make it revenue neutral. Since then also Brookings has come out with a proposal which is virtually the same thing that I have got. They have used the better name of the cash flow income tax. And they have added some credibility to the concept.

Senator SYMMS. Thank you very much.

Senator CHAFEE. Well, thank you very much. And, again, we want to say, Congressman Heftel, how delighted we are to see you back and doing so well.

Mr. HEFTEL. Thank you very much, Mr. Chairman.

Senator SYMMS. I assume you are unopposed in your election this year.

Mr. HEFTEL. I have an opponent, but I can't remember his name. [Laughter.]

Senator SYMMS. He's wasting his time.

[The prepared written statement of Congressman Heftel follows:]

TESTIMONY OF CONGRESSMAN CECIL HEFTEL
CONCERNING CASH FLOW INCOME TAX
SEPTEMBER 20, 1984

Mr. Chairman, I appreciate the opportunity to testify before your Committee today to discuss the need for reform of our current income tax system.

The present income tax structure is so weak and diminished by exclusions, deductions, exemptions, credits and other tax privileges that it is no longer capable of distributing the tax burden in an equitable manner.

At the same time long term U.S. economic growth has been poor at best. Our saving and investment rates are lower than our faster growing allies of Canada, Japan, France and West Germany. Today, income is taxed when it is first earned and, again, when the savings generate additional income. The U.S. income tax code discourages saving and subsidizes consumption.

The taxation of cash flow provides the best incentive for savings and investment. Under the cash flow income tax system, all income is taxed once -- either at the time of consumption or at the time of death in estate tax form. Cash flow tax can be deferred as long as one's lifetime, providing the stimulus for capital formation. The formation of capital will result in positive, long-term economic growth and enhanced employment.

Therefore, I introduced H.R. 5841, the Progressive Consumption Tax Act of 1984, which would have provided for tax reform and reduction of the federal budget deficits. However, we have redrafted it as revenue neutral, so that it can be compared directly with the other proposals which are designed to be revenue neutral. I am proposing a cash flow tax which will assess people according to their personal expenditures, not according to their income. People would be taxed not by how much they put into the national product, but how much they take out.

In this bill, annual cash flow is derived by calculating the value of his or her total receipts in the year using the W-2 and 1099 forms as presently used. From that value is subtracted the amount of net savings and investment made by the taxpayer during the year. The difference between what was received and what was saved over the year is cash flow - the tax base.

It is necessary that the taxable base of the cash flow tax be broader than that of any income base since consumption by definition is smaller than income. Thus to raise adequate revenue levels, the tax base or tax rate on a comprehensive cash flow base would have to be higher than that on a comprehensive income base.

In addition to the inclusion of all forms of income in the taxable base -- net capital gains, all dividends and (most) interest, retirement income and all gifts, bequests, unemployment compensation would be considered part of the taxable base.

The remainder of the taxable base would be made up of net borrowing amounts for that year. However, borrowing to buy a principle residence is excluded from the tax base. Conversely, debt repayment is subtracted from the base, or the adjusted gross cash flow.

A limited number of deductions, or a standard deduction, would be subtracted from AGCF and graduated tax rates would be applied to the taxable cash flow.

Deductions allowed to be subtracted for individuals include: (1) mortgage interest payments on principal residence and interest on indebtedness for purchase of investment assets and that incurred in the conduct of trade or business (whether personal or partnership); (2) medical expenses in excess of 5 percent of adjusted gross cash flow; (3) charitable contributions up to 5 percent of an individual's adjusted gross cash flow; (4) state and local income taxes; and, (5) uninsured property losses in excess of $500.

We would also provide credits of $200 for each personal exemption, which is equivalent to a $2,000 exemption. However, the credit provides the same value at the 30% consumption rate level, as it does at the 10% level.

The bill repeals most of the current credits and deductions provided for businesses and individuals. Depreciation for property placed in service by the corporation during the taxable year would be expensed or subtracted to arrive at adjusted net income. Indexing would not be necessary since the current value of money is the basis for the tax. Therefore, inflation has no effect on the rates. As an offset to the expensing of depreciation, which is most attractive for capital formation, current deductions for capital gains, investment tax credits, and foreign tax credits would all be repealed. Similarly, fringe benefits, such as contributions by employers to health and life insurance plans, would be included in the individual's taxable base. The amount of medical insurance added to the taxable base would likewise be accrued toward the 5% of adjusted gross cash flow level necessary for the medical deduction. Deductions for real and personal property taxes would also be repealed.

We provide for three progressive rates, taxing a family of four at a level of $12,000 in consumed income. The rates will be: 10 percent, for married individuals filing jointly up to $15,000 in consumed income, and unmarried individuals up to $12,000; 23 percent for married individuals filing jointly and unmarried individuals up to the Social Security wage base; and 30 percent for those above the Social Security wage base. The indexing of the social security wage base provides for automatic indexing of the 30% rate. However, language to index other individual rates could be incorporated. Meanwhile, corporations would pay one effective rate of 30%.

We provide for zero bracket amount deductions of $4,000 for individuals, $6,000 for heads of household, and $8,000 for joint returns. A tax credit of $200 is included for each dependent claimed.

A cash flow tax system would simplify our tax code by repealing the loopholes listed in today's massive number of deductions and credits. Expensing of depreciation and incentives for savings and investments will provide the mechanism for the increased capital formation needed for revitalization of American business.

A cash flow tax system is workable, simpler, and more effective in developing the capital necessary for long-term economic growth.

Mr. Chairman, thank you for this opportunity.

Senator **Chafee**. Now the next panel will be Mr. Raymond Scheppach, James Hacking, and Mr. David Silverman. And while they are coming up, I want to say that I welcome this debate. I believe that the testimony that we are having and have had and will continue to have is extremely helpful. I believe that we are going to make some changes in the code in 1985. Despite Mr. Mondale's charge, the President does not have a secret plan to raise taxes. The Treasury Department study, which the President commissioned, will not be out until December, and I don't think that the Treasure Department is any different from the rest of us. They are probably going to put off their study just as most of us did when we had to turn in term papers in school. They will put off the details until the last moment.

So all the hearings that we are having here and in the Ways and Means Committee are a warm-up to what we are going to be doing in 1985. The real debate will be coming then.

It seems to me that the American public does want tax changes. I, personally, in our office receive dozens of postcards every week advocating a flat tax. The polls reveal that the American public thinks that the Federal income tax is not fair, and most people, according to polls that I have read, would prefer a national sales tax. But I'm not sure that once they studied that more carefully that's what they would want.

So we don't have any simple choice before us. We have discussed the Bradley-Gephardt. We have discussed the Kemp-Kasten. These aren't simply flat taxes. They have sophisticated alternatives, progressive alternatives to the current system. I don't want in any way to throw cold water, as I say, on this debate. We look forward to it and we are seriously going to be looking at all the alternatives.

We really don't have much time next year. We have got such a full menu before this committee. As I mentioned before, I would certainly oppose a surtax to raise revenue, but I would suggest that we look at taking all the deductions and credits that currently are used to arrive at taxable income, and instead of scratching some of them or saving some of them, perhaps one of the things we might do is just scale all of them down. That is, reduce them by 10 or 15 percent. And this, seems to me, is much fairer than a surtax because it raises the taxes for those who in many instances, as I have stated, are not paying there fair share

We have got an interesting year coming up, and all the testimony is going to be most helpful. So we look forward to the panel before us now.

And, Mr. Scheppach, why don't you proceed first. He is with the National Governors' Association.

STATEMENT OF RAYMOND C. SCHEPPACH, EXECUTIVE DIRECTOR, NATIONAL GOVERNORS' ASSOCIATION, WASHINGTON, DC

Mr. **Scheppach**. Thank you, Mr. Chairman.

Let me submit my full statement for the record and I will try to summarize it in the 1 minute allotted.

Let me first commend this committee for beginning the debate on tax reform. The Governors are aware that the American taxpayer and academic experts alike believe that the Federal tax system is seriously deficient with respect to the three goals of any tax system—simplicity, fairness, and efficiency.

A recent poll by ACIR indicated that the Federal income tax is now the worst tax in the view of the taxpayers. From the State perspective, there is a growing concern that the decreasing confidence in the Federal tax system will be transferred to State and local taxes.

In view of the growing congressional interest in tax reform and the President's directive for an options paper, the Governors have established a task force on tax reform, chaired by Governor Lamm of Colorado. Other members of this task force include: Governor Thornburgh of Pennsylvania, Governor Alexander of Tennessee, Governor Carlin of Kansas, and Governor Matheson of Utah.

It is our current plan to adopt a comprehensive tax policy at our winter meeting in February.

With respect to your overall considerations, I would just like to leave with you two major points. First, Federal tax policy decisions do affect State revenue collections and must be made with full knowledge of this impact on States. For example, 45 States currently levy a general sales tax. The rates range from a low of 3 percent to a high of 7.5 percent. The average Federal tax savings from the deductibility provision per itemizing taxpayer is about $60. The per capita effect, however, runs from $105 in New York to $2 in Oregon.

Consequently, the elimination of this deduction would have major differential effects across States.

A similar situation is found in the individual income tax. The definition of income used by the States varies greatly; 29 States, for example, use the Federal definition of income, 11 use their own and 4 use the Federal tax liability. Thus, again, any option to broaden the tax or make other changes can have major differential impacts on the States.

Similarly, the same pattern holds for corporate taxes. The 1981 tax bill with its accelerated cost recovery system affected State tax revenues directly. A number of States had to adjust their corporate taxes on an emergency basis due to your changes. In any tax change, a transitional period for States is essential, particularly because States cannot run deficits due to constitutional restrictions. In 1981, tax changes were particularly troublesome given the overall weakness in the economy, the decline in State tax revenues and the cuts in Federal grants.

The second major point, Mr. Chairman, is that States are pattners with the Federal Government in the funding and the administration of many critical programs. So Governors should be full participants in the decisions that affect the States' capacities to meet their obligations.

That completes my summary, Mr. Chairman. I will be very happy to answer any questions.

Senator **Chafee**. Fine. Thank you very much.

[The prepared written statement Mr. Scheppach follows:]

National Governors' Association

John Carlin
Governor of Kansas
Chairman

Raymond C. Scheppach
Executive Director

STATEMENT

OF

RAYMOND C. SCHEPPACH
EXECUTIVE DIRECTOR
NATIONAL GOVERNORS' ASSOCIATION

Before the

COMMITTEE ON FINANCE
UNITED STATES SENATE

On

TAX REFORM AND SIMPLIFICATION

September 20, 1984

HALL OF THE STATES · 444 North Capitol Street · Washington, D.C. 20001 · (202) 624-5300

Mr. Chairman and Members of the Finance Committee:

At the outset of my testimony, I wish to thank you, Mr. Chairman, and the members of the Finance Committee for the leadership you have shown in debating and acting on some of the most complicated and important issues facing our nation today.

In my statement, I will summarize the state perspective on the importance of tax reform, illustrate the profound and varied effect that federal tax decisions have on state governments, and update you on actions taken by the Governors to prepare for the coming debate on tax reform. Two critical points I wish to make to you are:

- First, federal tax policy decisions do affect state revenue collections and must be made with full knowledge of their impact on states.
- Second, states are partners with the federal government in the funding and administration of many critical programs, so Governors must be full participants in decisions that affect the states' capacity to meet their obligations.

Impetus for Tax Reform

State and local governments get most of their revenues from taxes they impose, not from the federal government. As the experience of 1981 and 1982 proved again, weakness in the national economy translates into severe fiscal stress for state governments, cutbacks in their programs, increases in state taxes to maintain existing programs, and a general inability to make necessary program expansions or start new priority initiatives.

The national economy has made a strong comeback. While states are recovering from the recession, the results of our latest survey indicate that the states' balances are still well below the levels reached in fiscal years 1979 and 1980. In those years, aggregate ending balances exceeded $11 billion, and, as a percent of expenditures, the balances exceeded 9 percent. Overall, we estimate that states will end their 1984 fiscal years with an aggregrate balance around $5 billion, which is equal to approximately 3 percent of expenditures and is still below the 5 percent considered a prudent balance by most Wall Street analysts.

In any case, the overriding interest of Governors in federal tax policy is the same as the Finance Committee's: that the tax code be part of a national economic policy that promotes U.S. competitiveness and gains in real output. We urge the Committee to study carefully the effect of tax reform options on the economy and to continue its efforts to ensure that the tax code does not constitute an obstacle to economic growth.

Beyond this broad concern, Governors are aware that American taxpayers and academic experts alike believe that the federal tax system is seriously deficient with respect to the three goals of any tax system — simplicity, fairness, and efficiency. A 1983 poll conducted by the Advisory Commission on Intergovernmental Relations (ACIR) asked the public to identify "the worst tax." The federal income tax attracted a 35 percent response, substantially higher than the second worst tax, the property tax, with 26 percent. In response to the same question in 1972, only 19 percent chose the federal income tax as the worst tax.

From the state perspective, there is growing concern that the decreasing confidence in the federal tax system will be transferred to states. Specifically, concern on the part of taxpayers that the federal income tax is unfair or is too high can create an unwillingness to comply fully with other taxes perceived as being part of the same system (e.g., a state income tax.) State and local officials therefore have a stake in the simplification and improvement of the federal tax code, because disillusionment with federal taxes may affect state revenue collections.

State Tax Profile

Although Governors support federal efforts to simplify the federal tax system, NGA does not underestimate the difficulty of the task. Moreover, Governors are well aware that such changes could have a major impact on state government. The interconnection between the federal tax code and state tax provisions is very close, and the varied nature of state tax laws means that a revision in the federal law will affect states in widely differing ways. It is for these reasons that federal tax policies involve more than a federal revenue decision; they often have an important impact on the intergovernmental system as well.

Let me give you a few examples that illustrate how state general sales, income, and corporation net income taxes —the three largest sources of state revenue — are affected by federal tax decisions. Forty-five states levy a general sales tax (as distinct from selected sales taxes); the rates range from a low of 3 percent (in 7 states) to a high of 7.5 percent (in one state, Connecticut). As a group, states raise over 30 percent of their tax revenue through the general sales tax, but the importance of the tax varies widely when viewed on a state-by-state basis, as table 1 shows. The state of Washington relies most heavily on the general sales tax, generating 58.6 percent of its tax revenue using this method, while in the five states without a sales tax — Alaska, Delaware, Montana, New Hampshire and Oregon — the percentage generated is obviously zero.

Why is the variation in state sales tax rates relevant to federal tax policy? For one thing, it explains why many states view continuation of federal tax provisions permitting deductibility of sales taxes as an important priority. The average federal tax savings from the deductibility provision per itemizing taxpayer is approximately $60, but the per capita effect is $105 in New York, $85 in Washington, and $2 in Oregon (See table 2). This variation makes reaching consensus on the sales tax deductibility issue more difficult and suggests that if federal changes were made, major revisions in state tax laws would likely follow.

The base of the sales tax also varies greatly among the states, as table 3 shows. For example, 42 states exempt prescription medicine, 41 states exempt barber and beauty services, 24 exempt auto repair services, and so on down the list. This fact is important because it suggests that administration of any national sales tax would be more difficult than many suppose. Businesses not now subject to a state sales tax presumably would be covered by a national tax. The resulting paperwork and confusion for both the private sector and the Internal Revenue Service could be considerable.

Turning to the individual income tax, we see the same pattern. Forty-three states currently levy an income tax, but the tax in Connecticut, New Hampshire, and Tennessee affects only interest and dividends, not wages and salaries. Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming have no income tax at all. About 30 percent of state revenues nationwide are generated by the income tax, but in Oregon (which does not have a general sales tax) over 66 percent of the state revenue is raised through a tax on personal income. Of course, the seven states without an income tax get none of their revenue this way (see table 1).

The definition of income used by the states also varies greatly; 29 states use the federal definition of income as the basis for state tax liability, 11 states use their own definitions of income, and four states use federal tax liability (see table 4). It is easy to see that the Individual Retirement Account provisions included in the Economic Recovery Act of 1981 (ERTA) would have a dramatic effect on states that "piggy-back" on federal income definitions; state officials had to deal not only with the revenue consequences of unpredictable economic conditions in 1981, but unpredictable federal tax policy as well.

The same pattern also holds for state corporate taxes. About 8 percent of state revenues across the country come from a corporate income tax, but tax rates and reliance on the corporate tax vary widely. Indiana has adopted a rate of 3 percent, while Iowa and Minnesota apply a rate of 12 percent. Five states (Nevada, South Dakota, Texas, Washington and Wyoming) have no state corporate income tax, while New Hampshire raises 22 percent of its revenue through a corporate tax.

Before 1981, most states used federal definitions of corporate income for their own tax systems, so when ERTA established a new and more rapid form of depreciation known as the Accelerated Cost Recovery System (ACRS), state tax revenues were affected directly. After ERTA's enactment, states had to decide whether and how to follow the new federal depreciation provisions. In many cases, state legislation that was enacted in 1981 or 1982 on an emergency basis had to be revised in 1983 after states had an opportunity to assess the impact of the federal change. Thirteen states have decided not to allow part of ACRS and five states (California, Georgia, New Jersey, New York and Oregon) do not use the federal definition of ACRS at all. Most states had sought to rely on federal definitions as a convenience to corporations, but this objective has been compromised because the resulting revenue loss was too great for many states. Moreover, the very short lead time afforded states to examine the potential effect of the federal change required action without full analysis, leading to further changes in state tax codes and further inconvenience for corporations.

I have concentrated on the fifty states in the state tax profile I have provided here, but I must note that the U.S. flag territories have developed similar reliance on the federal tax code. The very name of the practice used in several of the territories — the mirror system — should alert policymakers to the impact that federal tax code changes have on the revenue systems of the territories.

To summarize then, the federal tax code is woven into the fabric of state tax systems in a myriad of ways. Federal decisions must take this fact into account by determining before enactment what the effect of a proposal on states would be and by consulting with state officials, and permitting adequate lead time for states to adjust if there is to be a tax code revision affecting them.

NGA Task Force on Tax Reform

In view of the growing congressional interest in tax reform and of the President's directive that he receive an options paper on the issue by the end of the year, Kansas Governor John Carlin, Chairman of the Association, has established a Task Force on Tax Reform. The Task Force will be chaired by Colorado Governor Richard Lamm, and Governors Carlin, Thornburgh of Pennsylvania, Alexander of Tennessee, and Matheson of Utah will serve as members. The charge to the group is to analyze the range of tax reform options now being proposed and to complete the background work necessary to enable the Governors to be active in the coming debate. It is our current plan to discuss tax reform in some detail at our winter meeting in February, and, if necessary, adopt a comprehensive policy at that time.

The work of the task force is still in the very early stages, but it appears that we will be focusing on four major reform alternatives: a flat tax, a modified flat tax, (such as the Bradley-Gephardt or the Kemp-Kasten proposals), a "cash flow" (or personal expenditure) tax, and a value added/retail sales tax.

We are looking at the flat tax and the modified flat tax as possible responses to widespread public concern that the tax code is unfair, due in part to the $270 billion in deductions and credits that have been incorporated in it over the years. Broadening the income tax base has the potential to improve the efficiency, simplicity and fairness of the federal tax system. Such a reform also has the potential of reducing marginal tax rates, which should increase incentives to work, save, and invest.

From a state and local government perspective, however, proposals to broaden the tax base immediately raise a number of issues. The changes could affect the deductibility of state and local income, property, and general sales taxes, which will weaken public support for state taxes. Furthermore, changing federal tax provisions relating to the deductibility of one particular state tax (e.g., sales tax) present a major problem because the value of the deduction differs substantially among the states, as I pointed out earlier.

The priority states have placed on maintaining the tax-exempt status of municipal bonds has been conveyed to you in numerous forums over the years. More than one-third of all state and local capital expenditures are financed through provisions in the tax code affecting general obligation and revenue bonds, and preservation of these provisions is of the highest priority, given the importance of infrastructure to the economy. Therefore, this issue also will be a subject of study by the Task Force.

The cash flow and value added/retail sales taxes are on the agenda because we recognize that from a long-run economic standpoint, these taxes have the advantage of using actual consumption as the base. Such an approach should reduce consumer spending and increase savings, leaving more money available for investment and leading to higher productivity and growth in the long run. All other things being equal, these taxes should have the effect of reducing interest rates and increasing investment. On the negative side, however, sales and value added taxes can be regressive. Furthermore, if they are imposed without a concurrent deduction in the federal income tax, the tax system would maintain many of the efficiency and fairness problems which the reform effort is to address.

From the state and local perspective, these consumption-oriented taxes pose a problem because they intrude into the tax area traditionally relied upon by state and local government. In addition to the general sales tax, which I mentioned earlier, states impose selected sales taxes. Taken together, total sales and gross receipts taxes account for 49 percent of state tax collections.

Conventional wisdom holds that taxpayers will resist taxation above a certain threshold. The difference between current taxation and the threshold is the "tax room," and any federal use of the tax base eats up what is left for state and local government use. Also, federal consumption taxes might tend to reduce national spending as consumers shift their consumption patterns in response to price increases due to the imposition of a sales or a value added tax. Any reduction in sales would also reduce state and local tax revenues to the extent that they depend on consumption. For these reasons, Governors would be very concerned about the imposition of major new federal consumption taxes.

Conclusion

In summary, our work on the tax issue to date suggests that states will apply the following criteria to any federal tax reform initiative:

- It must create incentives for real economic growth, providing long-term benefits to our people and offering an adequate revenue base to support the programs of federal, state, and local governments.

- It must ensure that the burden of any changes fall equitably on all affected by the tax system.

- It must recognize the close connection of the federal and state tax systems. Some tax code provisions — affecting tax-exempt bond financing and deductibility of state and local taxes, for example, are clearly of an intergovernmental nature. But federal decisions on matters which do not appear related to state governments — such as the Accelerated Cost Recovery System and Individual Retirement Accounts — also have an important impact on states. This interweaving of state and federal tax codes means that careful study of the full effect of a proposed change is essential prior to its enactment and that adequate lead time must be provided to enable states to adjust their systmes as necessary.

- It must recognize that a marked expansion of federal reliance on excise or sales taxes will have a widely varying impact from state to state and could hamper some states' ability to raise additional revenues at a time when many important responsibilities are being assumed by state governments.

- It must incorporate the results of extensive consultation with state officials.

In any reform of the federal tax system, states must be viewed as partners in the advancement of public policy improvements, not as just another interest group. Our concerns, which by necessity must be expressed in terms of specific comments and proposals, reflect truly generalized apprehension about the overall health of the economy and the condition of the federal budget.

The states and the federal government have a commonality of interest in maintaining a growing and productive economy, which is the source of both our tax bases. In addition, we have a shared responsibility in the funding and administration of many critical government services, ranging from health and welfare programs to transportation and environmental programs. These shared responsibilities argue for specific evaluation of the impact of each proposal on state and local governments. The National Governors' Association stands ready to assist you in this regard.

TABLE 1

STATE GOVERNMENT TAX COLLECTIONS IN 1983

Percent Distribution of State Government Tax Revenue for Selected Taxes

STATE	General Sales	Individual Income	Corporation Net Income
Alabama	28.2	23.8	5.7
Alaska	(X)	.1	13.0
Arizona	41.0	23.3	7.8
Arkansas	32.7	29.0	6.5
California	34.9	34.4	11.5
Colorado	35.7	37.6	3.2
Connecticut*	43.5	7.0	14.1
Delaware	(X)	49.1	4.7
Florida	53.6	(X)	6.0
Georgia	33.5	38.3	6.8
Hawaii	52.2	30.2	1.9
Idaho	26.7	36.1	5.0
Illinois	32.3	29.7	8.1
Indiana	47.6	25.6	4.4
Iowa	28.4	35.9	6.9
Kansas	31.8	33.9	9.0
Kentucky	26.9	24.9	6.6
Louisiana	27.8	7.6	10.7
Maine	34.7	30.2	4.2
Maryland	24.9	42.1	4.3
Massachusetts	20.4	48.0	12.8
Michigan	28.0	36.6	14.3
Minnesota	23.0	45.8	5.9
Mississippi	49.5	13.1	4.5
Missouri	37.3	33.5	4.5
Montana	(X)	29.5	7.0
Nebraska	36.1	28.4	5.2
Nevada	47.3	(X)	(X)
New Hampshire*	(X)	5.1	22.4
New Jersey	27.1	23.5	10.8
New Mexico	41.0	1.4	5.3
New York	21.8	51.1	8.3
North Carolina	20.5	38.5	7.6
North Dakota	27.8	6.7	5.8
Ohio	29.8	29.3	6.2
Oklahoma	15.6	24.8	3.9
Oregon	(X)	66.3	7.0
Pennsylvania	28.1	24.3	9.8
Rhode Island	29.2	35.9	5.8
South Carolina	32.7	34.0	6.1
South Dakota	53.5	(X)	.8
Tennessee*	52.4	2.3	9.1
Texas	36.8	(X)	(X)
Utah	40.2	35.5	3.2
Vermont	18.6	31.8	7.1
Virginia	20.7	44.5	5.3
Washington	58.6	(X)	(X)
West Virginia	50.7	-21.1	3.1
Wisconsin	28.1	40.4	7.9
Wyoming	25.8	(X)	(X)

* Income tax is not a tax on wages and salaries; it affects only interest and dividends.

SOURCE: State Government Tax Collections in 1983
U.S. Department of Commerce, Bureau of the Census

TABLE 2

FEDERAL TAX SAVINGS FROM DEDUCTIBILITY PROVISION, PER TAXPAYER,a/ BY STATE, 1980

	Deductibility of All State and Local Taxes	Deductibility of Sales Taxes Only
Alabama	$273.64	$74.41
Alaska	326.92	42.24
Arizona	322.68	75.65
Arkansas	312.36	45.45
California	591.37	89.45
Colorado	400.23	69.35
Connecticut	528.39	96.70
Delaware	614.45	7.68
Washington, D.C.	916.74	75.47
Florida	226.91	58.76
Georgia	392.94	60.20
Hawaii	564.14	83.88
Idaho	345.96	40.59
Illinois	432.31	88.44
Indiana	271.83	58.89
Iowa	413.47	43.03
Kansas	378.73	54.00
Kentucky	371.21	57.94
Louisiana	192.01	82.36
Maine	439.04	56.22
Maryland	640.19	67.89
Massachusetts	656.90	47.62
Michigan	553.47	59.02
Minnesota	584.38	45.21
Mississippi	277.23	76.56
Missouri	342.54	66.21
Montana	315.96	3.26
Nebraska	445.44	63.42
Nevada	192.89	49.02
New Hampshire	348.78	7.49
New Jersey	569.05	66.05
New Mexico	295.62	73.89
New York	892.12	105.01
North Carolina	417.11	50.93
North Dakota	251.24	37.71
Ohio	346.53	51.70
Oklahoma	335.65	57.37
Oregon	461.70	2.16
Pennsylvania	445.33	58.74
Rhode Island	547.65	60.89
South Carolina	341.30	54.46
South Dakota	230.15	72.00
Tennessee	203.03	89.16
Texas	232.78	75.57
Utah	329.37	62.41
Vermont	521.44	33.16
Virginia	477.91	58.66
Washington	234.82	85.68
West Virginia	344.22	50.32
Wisconsin	573.05	49.95
Wyoming	161.71	73.46
U.S. Average b/	$410.21	$59.37

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a/ Number of taxpayers was calculated by adding number of single returns itemizing state-local taxes to twice the number of joint returns itemizing state-local taxes. In 1980, 31% of all returns itemized state-local taxes. 96% of the returns itemizing some state-local tax itemized sales tax deductions. (Internal Revenue Service, Statistics of Income--1980, Individual Income Tax Returns, Washington, D.C.: U.S. Government Printing Office, 1982, Publication 79 (9-82), pp. 36, 56.)

b/ U.S. total excludes Puerto Rico and citizens abroad.

Source: ACIR staff computations using unpublished 1980 IRS Individual Income Tax Model file.

TABLE 3

MAJOR SALES TAX EXEMPTIONS, 1984

	Number of States Exempting
Consumer Goods	
Groceries	28
Prescription medicine	42
Motor fuels	37
Alcoholic beverages	4
Cigarettes	12
Services	
Residential gas and electricity	27
Residential water	38
Telephone and telegraph	18
Laundry and dry cleaning	28
Barber and beauty services	41
Amusements	21
Management consulting	43
Computer and data processing	26
Legal services	43
Maintenance services	37
Auto repair services	24
Agricultural Goods	
Feed, seed, fertilizer, etc.	43
Agricultural machinery	24
Business Goods	
Sales for resale	44
Production machinery	30
Materials used in processing	44

SOURCE: State of Texas Revenue Department

TABLE 4

DEFINITIONS OF INCOME USED BY THE STATES AS THE STATE INDIVIDUAL INCOME TAX BASE

STATES THAT USE FEDERAL DEFINITION OF INCOME FOR STATE TAX BASE 29 STATES AND D.C.	STATES THAT USE THEIR OWN DEFINITION OF INCOME FOR STATE TAX BASE 11 STATES	STATES THAT USE FEDERAL TAX LIABILITY FOR STATE TAX BASE 4 STATES
Arizona	Alabama	Nebraska
Colorado	Arkansas	North Dakota*
Delaware	California	Rhode Island
DISTRICT OF COLUMBIA	Connecticut	Vermont
Georgia	Mississippi	
Hawaii	New Hampshire	
Idaho	New Jersey	
Illinois	North Carolina	
Indiana	Pennsylvania	
Iowa	South Carolina	
Kansas	Tennessee	
Kentucky		
Louisiana		
Maine		
MARYLAND		
Massachusetts		
Michigan		
Minnesota		
Missouri		
Montana		
New Mexico		
New York		
North Dakota*		
Ohio		
Oklahoma		
Oregon		
Utah		
VIRGINIA		
West Virginia		
Wisconsin		

STATES WITH NO INCOME TAX
7 STATES

Alaska
Florida
Nevada
South Dakota
Texas
Washington
Wyoming

*Taxpayer has option of choosing method of calculation.

Source: "Comparison of Selected Tax Rates in the District of Columbia With Those of the Fifty States" D.C. Government June 1983

STATEMENT OF JAMES HACKING, ASSISTANT LEGISLATIVE COUNSEL, AMERICAN ASSOCIATION OF RETIRED PERSONS, WASHINGTON, DC

Senator CHAFEE. Mr. Hacking.

Mr. HACKING. Thank you, Mr. Chairman.

I'm the assistant legislative counsel for the 16.7 million member American Association of Retired Persons. This morning I'm accompanied by my colleague, David Certner, who is one of our legislative representatives specializing in tax issues.

I will submit the association's statement for the record and summarize.

The economic expansion is now well into its second year. The rate of growth has begun to slow. The leading economic indicators for the past 2 months indicate further slowing of the economy next year. That may, in fact, anger the onset of economic stagnation, if not another outright recession.

AARP believes that to sustain the economic expansion, the administration and the Congress will have to fashion a major deficit reduction package next year. In the process of doing that, there will be a major debate over spending reductions versus revenue increases and over defense spending reductions versus entitlement program spending reductions.

Inevitably, we feel significant amounts of new revenue will have to be raised through one or more existing or new tax mechanism. The magnitude of the revenue to be raised and the choice of instruments selected to raise it must obviously take into account differential effects on the economy as we expect it to be in 1985 and 1986. But there are other considerations that should be taken into account as well—important tax equity considerations. Given that, our analysis indicates that at this point AARP could not under any circumstances support any of the value added, national sales or consumption taxes that are under consideration.

However, we do feel that the Congress would be well disposed to take a close look at the modified flat-rate tax plans that are out there at this point in time. But there are a number of concerns to be taken into account will respect to them.

First, any modified flat tax plan which is adopted must actually raise significant new revenue. It is not enough to be revenue neutral.

Second, there should be a clear set of guiding principles that would be used to determine which tax preferences these plans should retain. Certainly a modified flat tax plan that raises revenue, maintains progressivity, and simplifies the Tax Code without being inequitable in the redistribution of the tax burden downward would have much to recommend it over the current system.

That concludes my statement. I thank you, Mr. Chairman.

Senator CHAFEE. Well, thank you, Mr. Hacking.

[The prepared written statement of Mr. Hacking follows:]

STATEMENT

of the

AMERICAN ASSOCIATION OF RETIRED PERSONS

before the

SENATE COMMITTEE ON FINANCE

on

PROPOSALS TO REVISE THE TAX CODE

September 20, 1984

The American Association of Retired Persons, the nation's largest aging organization with nearly 17 million members over the age of 50, welcomes the Finance Committee's attention to the tax reform issue. To the extent the various reform proposals focus public attention on the need for tax reform -- even if that reform is simply a thorough review and evaluation of present tax preferences -- this is a welcome endeavor.

AARP shares the deep concern of many regarding the huge budget deficits, estimated by the Congressional Budget Office to be $172 billion this year and expected to reach over $200 billion by 1989. Our membership regards reduction of these tremendous budget deficits as a major legislative imperative. At the same time that deficits are brought under control, however, equity must be maintained. Several legislative options have been presented to the Finance Committee as alternatives or additions to the current tax system which would not maintain equity for the elderly and other low-income segments of the population -- the so-called "flat" taxes, including the Value-Added Tax (VAT), and the consumption tax plans.

The flat tax approach has been applied to various tax systems, including sales tax, consumption tax, and income tax systems. Proponents of a "pure" flat tax -- a tax which would discard the current graduated tax rate in favor of a single tax rate, regardless of taxpayer income -- argue that a flat tax approach, combined with base broadening, is the best means to achieve equity and an understandable tax system. Tax rates would be lowered, under a flat tax system, by eliminating tax preferences.

Critics of flat taxes note that rates for lower and middle income taxpayers may increase if a flat rate approach is adopted, particularly if the flat rate system is intended to be revenue neutral. An exemption could be built into the system to protect low income persons and retain some degree of vertical equity, but such an exemption, because of the tax broadening measures, would have to be substantial.

Advocates of the flat tax approach admit that lowered tax rates for higher income persons will mean higher rates for lower income persons, but argue that the increase experienced will only be temporary because increased economic activity will eventually further reduce the flat tax rate for all persons.

The VAT tax, which is an expenditure version of the flat rate approach, would assess a tax on the product at each stage in the chain of distribution. The tax, as a result, would be "hidden", effectively built into the product cost at the consumer level. (This differs from a sales tax, which is assessed only at the retail level.)

The consumption tax, which has been suggested with both flat and progressive tax rates, would assess taxpayers based on amounts spent, as opposed to amounts earned. This tax system is intended to increase savings and investment and thereby encourage economic growth. Although income would continue to be reported, the tax could reach consumption by requiring the taxpayer to report not only earnings, but also borrowing, savings account withdrawals, and assets sales proceeds. Amounts invested or saved during the taxable year could then be deducted. Under a consumption tax, many present deductions would no longer be available.

While simplification of the tax code is a desirable objective, the elimination of the progressive rate structure is not. Tax reform should not mean abandonment of the longstanding and sound principle that federal income tax liability should be based on "ability-to-pay". Flat taxes, and those based on expenditures would have a particularly significant impact, inequitably redistribute the tax burden. Those persons of lower income and who by necessity must spend most of what they earn would suffer a disproportionately heavy tax burden.

When a tax system builds from the idea that it is best to tax when a person needs to borrow or spend their savings, as would be the case under a consumption tax plan, it is those persons in the middle and lower income brackets who will carry the weight of the tax burden. Particularly affected will be the elderly who, no longer able to work, must spend their savings on living expenses. After a lifetime of saving and planning for retirement, the elderly are hit especially hard by the regressive nature of consumption taxes. Students, the unemployed, and families taking out loans for major purchases would also be severely impacted by a consumption-based plan. The recently released Joint Committee on Taxation's analysis of tax reform proposals noted that, under a consumption tax, the elderly, the unemployed, and parents putting their children through school would be worse off than under the present income tax.

Under the proposed sales tax or consumption plans, taxes would increase for those who are able to save less, and an additional tax burden would fall on persons who are currently liable for little or no tax because their incomes are so low. Conversely, those who spend only a small percentage of their income will find a decrease in the amount of their tax burden.

The regressive nature of a flat tax based on consumption is not readily avoidable through adjustment of the tax rates, as some proponents have indicated. Because the percentage of income wealthy individuals must spend is far less than what middle and lower income people must spend, graduating the rates to the degree needed to maintain the progressivity of the present system would be impractical. Such adjustment would be made even more difficult because tax rates would have to start higher simply to have a revenue neutral system, since consumption will, by definition, always provide a smaller tax base than an income-based system.

Tax reformers must not lose sight of the fact that the principle on which our tax system is premised -- that those who are most able to pay should pay more -- requires that tax be applied to the power to consume, not actual consumption. A tax on actual consumption would lessen the tax burden on higher income persons simply because they need spend far less a percentage of income to maintain their standard of living, and would ignore the fact that higher income persons have greater access to investment opportunities and the financial security to take advantage of them. Merely utilizing differential rates or even exempting expenses for food, clothing, housing and other necessities from the tax would fail to alleviate this basic flaw in a consumption tax system. Additionally, exemptions for certain necessities will require an increase in the tax rate generally, thus those who must still spend a large percentage of their income may not be better off.

Not only do the elderly as a group spend most of their income -- income that has already been taxed as it was being earned over a lifetime of work -- but they often spend a disproportionately higher percentage of income on necessities. Statistics reveal that the elderly spend twice the percentage of income on fuel and utilities and medical care than the average taxpayer does, and over 5% more on food. According to Census Bureau figures on 1982 household income, nearly 50% of elderly households have an annual income of less than $10,000. With lower than average incomes, and higher than average expenditures on basic necessities, the elderly will be forced to shoulder a tax burden they can neither bear nor prepare for.

A number of more specific objections have been made to the flat and expenditure tax ideas. Initially, horizontal inequity would result under these plans because no differentiation is made for household size, as under the present system. Therefore, a household with income identical to that of a single person would bear a much heavier tax burden since their expenses would be greater as a percentage of income.

The fact that the VAT tax is a "hidden" tax -- added on through the stages of production and subsumed in the consumer's cost -- means that raising such a tax rate would be politically much easier, as a change in such a tax would receive less attention since the tax is less visible. Such a system is more susceptible to political manipulation.

Although consumption tax proponents argue that their plans would provide incentives for savings, there is actually no clear evidence that savings will increase, as illustrated by the lack of any real effect on savings resulting from current tax breaks for capital income. Even if the amount of money available for borrowing does increase as a result of a consumption tax, the disincentive to spending that is created (since any money spent will be taxed) may well offset any stimulation caused by the consumption tax. The Congressional Research

Service, in its June 1984-released study, warned that since savings, under a consumption tax plan, would no longer be subject to tax, people might perceive that their pre-consumption tax savings objectives could be achieved with even less saved. The study concluded that there was no clear evidence that any increase in aggregate savings would result from a consumption tax.

Finally, the equity argument that loopholes would be eliminated through utilization of a flat consumption tax plan cannot be totally accepted. In fact, such a plan would greatly expand the present tax breaks for savings and investment into what may be considered one enormous loophole to be enjoyed by those with the most available means to spend.

Besides the "pure" flat and consumption-type plans, to which the Association is strongly opposed, a number of other reform options can and should be considered. Broadening the tax base by eliminating those tax expenditures which have outlived their economic purpose is one option. Considering the size of the budget deficit, revenue loss from outdated tax expenditures should not be tolerated. Not only could needed federal revenue be raised, but the tax laws could be simplified and higher tax rates avoided. Elimination of unnecessary tax expenditures would also reduce the use of income for tax avoidance, thereby lessening the distortion of economic activity and increasing dependence on the value of the investment opportunity. Equity would also be furthered if many of these expenditures are eliminated. It is estimated that at present only 30% of taxpayers take advantage of tax preferences. Also, part of the intended progressivity of the present system is defeated because current exclusions and deductions represent a higher rate of subsidy to higher income taxpayers. Unless a tax preference is refundable, taxpayers with no income are not even able to take advantage of the tax expenditure.

In examining the tax code for unnecessary tax expenditures which might be eliminated, the Congress must be mindful of the tax system's current role as a tool for implementation of social and economic policy. Eliminating all deductions and credits in favor of a tax system with no function but to raise revenue changes part of the tax system's current purpose. Without certain incentives built into the tax code, money for many beneficial purposes, such as charitable contributions, might dry up. Thorough examination must precede any decision to eliminate a current preference since many serve useful social or economic purposes.

The modified flat rate plans under consideration would substantially reduce tax rates, while keeping those rates graduated, and would do this by eliminating most tax preferences. These tax simplification plans merit close scrutiny. The Association does, however, have several general concerns regarding the modified flat rate plans.

First, any plan which is designed to be revenue neutral avoids the enormous problem of the budget deficit, a problem which requires immediate answers. A second difficulty with the proposed plans is that no guiding principles are presented to explain the selection of the tax preferences the plans do incorporate. Without a clear outline, the fairness the authors of these plans would hope to achieve may not be perceived as such by the public. Also, the lack of a systematic set of principles leaves open the door to political maneuverings and continuing pressure for the inclusion of more tax perferences so that the very purpose behind these modified flat rate plans -- to maintain revenue levels while simplifying tax regulations and lowering tax rates -- would be defeated. However, those modified flat tax plans that maintain progressivity and simplify the tax code without being inequitable in the redistribution of the tax burden should be carefully studied and considered.

Nearly everyone agrees that tax reform is necessary. The Association supports efforts at reform, but welcomes reform only if it is achieved through careful deliberation, and not at the expense of those lease able to bear a heavier tax burden. For these reasons, AARP strongly opposes those tax proposals -- among them pure flat taxes,consumption taxes, and VAT taxes -- which inequitably redistribute the tax burden to those with lower incomes, including the elderly, who are least able to afford it.

STATEMENT OF DAVID J. SILVERMAN, CHAIRMAN, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF ENROLLED AGENTS, BETHESDA, MD

Senator **CHAFEE**. Mr. Silverman.

Mr. **SILVERMAN**. Thank you, Mr. Chairman. My name is David J. Silverman. I'm chairman of the Government Relations Committee of the National Association of Enrolled Agents, whose members are tax practitioners enrolled to represent taxpayers before the Internal Revenue Service pursuant to Treasury Circular 230, 31 Code of Federal Regulations, part 10.

Our association supports this committee's efforts in attempting to simplify our tax laws. The National Association of Enrolled Agents believes that far too many sections of our Tax Code are written in an unnecessarily complex manner. And as a result, taxpayers are burdened with complex provisions that lack economic substance or purpose.

As complex as our tax laws are, there are many sections of the Tax Code that have served this Nation well. Itemized deductions for residential mortgage interest and real property taxes have helped bring home ownership to 65 percent of our Nation's households. Residential and business energy credits have helped us weaken OPEC's grip on our sources of energy. Itemized deductions for charitable contributions have helped us care for our less fortunate citizens. Medical research has been advanced and the humanities endowed by tax deductible contributions.

Tax credits have helped us rehabilitate and preserve our national landmarks. Pension and IRA deductions have assisted capital formation while providing retirement income.

Congress, its taxwriting committees in particular, should be complimented for what these deductions and credits have accomplished. I fail to see what purpose self-condemnation concerning our tax laws serves. By only seeing the hole in the doughnut, we lose sight of what it is we are trying to change. Realizing that a complete treatise on tax simplification is not possible in the amount of time the committee has been gracious enough to grant me, I would like to quickly review with you a few of my recommendations for simplifying page 1 and 2 of form 1040.

The filing requirement for when a tax return must be filed should be raised to the Department of Labor's poverty level. Income below this minimum level should be exempt from tax and no tax filing should be required.

The requirement that payors of dividends inform taxpayers of whether the dividend is either qualifying or nonqualifying for the purpose of the $100 dividend exclusion should be eliminated. The savings to American businesses would be enormous. Additionally, I don't believe that the complete elimination of the $100 dividend exclusion would make anybody either rich or poor.

Currently, the recipient of a pension benefit may elect one of the following six tax treatments: IRA rollover, special 10-year averaging, partial rollover, life time annuity, having it fully taxed or taxed at capital gains rates on pre-1974 contributions. I believe that this shopping list of tax treatments is extremely burdensome. Some of the methods reflect the improper tax treatment of pension benefits.

A pension is a wage continuation plan whose purpose is to provide a worker with an income after retirement and it should be treated as such for tax purposes. Pension benefits should either be paid out over the employee's life expectancy and taxed at ordinary rates, or if the employee feels that he could better manage his pension funds, he should be permitted to rollover the funds his employer has accumulated for him into an IRA with mandatory payments made over his life expectancy. These payments should be taxed at ordinary rates.

The computation required to determine if Social Security benefits are subject to tax should be eliminated. If it is necessary to tax Social Security benefits, they should be taxed in a manner similar to other annuities. Benefits should only be taxable after a worker has received back what he has paid into the Social Security fund. Social Security is nothing more than an annuity and should be treated as such.

Alimony deductions should be eliminated.

Senator **Chafee**. Well, on that particular point on the Social Security, they are not taxed at all on half of it and that in theory is the part that they have paid in.

Mr. **Silverman**. I realize that. The thrust of my testimony is how to simplify the filing of the form. Right now, retired people have to make a rather complicated computation as to what portion becomes taxable. I would like to see that changed to having it treated as an annuity. I think you would come back to the same effect because what they paid in would be almost equal to the part that is currently being excluded, that 50-percent portion.

Senator **Chafee**. You lost me in that.

Mr. **Silverman**. Could I try again?

Senator **Chafee**. Try again.

Mr. **Silverman**. Currently——

Senator **Chafee**. You don't even have to include half of it.

Mr. **Silverman**. That's correct.

Senator **Chafee**. So that's the part you paid in.

Mr. **Silverman**. That's correct. And my contention is if you treat it as an annuity, you would be back to the same situation, not being taxed on maybe half of it, if you deducted first what you paid into it. And that would relieve taxpayers of the necessity to make this annual computation as to what portion is taxable, if at all.

Senator **Chafee**. Let me take a look at that. I didn't think they had to make the computation.

Mr. **Silverman**. Well, they have to take all their income, including exempt income. If it falls over a certain threshold, then a maximum of 50 percent of the benefit becomes taxable. And it requires a rather elaborate computation on the part of our senior citizens. And I think this is an unfair burden. And I think proposals such as this could go a long way into simplifying the actual physical act of filing the form.

Senator **Chafee**. All right. Go ahead.

Mr. **Silverman**. Alimony deductions should be eliminated. An individual's tax liability shouldn't be affected by the decision to divorce. Divorce is a personal matter and should be treated as such without the Government subsidizing it. Alimony deductions are perhaps one of the most litigated of all deductions claimed by taxpayers, and may continue to be so notwithstanding the changes of the 1984 Tax Reform Act.

The investment credit should be either 8 or 10 percent. Currently, a taxpayer may elect a 10-percent credit instead of the 8-percent credit if he reduces the basis of the investment asset for the purpose of depreciation by 50 percent of the credit taken. I fail to see what purpose this election serves. If there is some purpose served by this basis adjustment, may I suggest that there be some threshold before a basis adjustment to the asset is required.

I believe that by a simple step-by-step commonsense approach we can simplify our tax laws without creating a State of utter confusion. I think that we all agree that change for the sake of change accomplishes nothing. We have seen the results of these types of changes in our schools.

I would like to call to the committee's attention that the fact that any tax simplification law that might be enacted will not simplify the way one-third of our Nation currently files their tax returns. In 1982, 95.3 million tax returns were filed. One-third of these were filed on form 1040-EZ or 1040-A. In 1984, 38 percent of all the individual returns filed through April 30th were filed also on form 1040-EZ and 1040-A. Of the 59 million taxpayers who filed their return on the long form in 1982, only 33.7 million claimed itemized deductions. So, currently, only one-third of all tax filers are claiming itemized deductions.

I would like to thank the committee for the opportunity to make my views known. If any member of the committee has any questions, I will be most happy to answer them.

Senator CHAFEE. Fine. Thank you.

[The prepared written statement of Mr. Silverman follows:]

STATEMENT ON TAX SIMPLIFICATION

BY
DAVID J. SILVERMAN
CHAIRMAN, GOVERNMENT RELATIONS COMMITTEE
NATIONAL ASSOCIATION OF ENROLLED AGENTS
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MADE BEFORE
THE UNITED STATES SENATE
HEARING ON TAX REFORM
SEPTEMBER 20, 1984.

Good Morning, Mr. Chairman.

My name is David J. Silverman. I am chairman of the Government Relations Committee of the National Association of Enrolled Agents whose members are tax practitioners enrolled to represent taxpayers before the Internal Revenue Service pursuant to Treasury Circular 230, 31 Code of Federal Regulations part 10.

Our association supports this committees efforts in attempting to simplify our tax laws. The National Association of Enrolled Agents believes that far too many sections of our tax code are written in an unnecessarily complex manner and as a result taxpayers are burdened with complex provisions that lack economic substance or purpose.

As complex as our tax laws are there are many sections of the tax code that have served this nation well.

Itemized deductions for residential mortgage interest and real property taxes have helped bring homeownership to 65% of our nations households.

Residential and business energy credits have helped weaken OPEC'S grip on our sources of energy.

Itemized deductions for charitable contributions have helped us care for our less fortunate citizens. Medical research has been advanced and the humanities endowed by tax deductable contributions.

Tax credits have helped us rehabilitate and preserve our national landmarks.

Pension and IRA deductions have assisted capital formation while providing retirement income.

Congress, its tax writing committees in particular, should be complemented for what these tax deductions and credits have accomplished. I fail to see what purpose self condemnation concerning our tax laws serves. By only seeing the "hole in the doughnut" we lose sight of what it is we are trying to change.

Realizing that a complete treatise on tax simplification is not possible in the amount of time the committee has been gracious enough to grant me, I would like to quickly review with you a few of my recommendations for simplifying page 1 & 2 of Form 1040.

The filing requirement for when a tax return must be filed should be raised to the Department of Labor's poverty level. Income below this minimum level should be exempt from tax and no tax filing should be required.

The requirement that payors of dividends inform taxpayers of whether the dividend is either qualifing or non qualifying for the purpose of the $ 100 dividend exclusion should be eliminated. The savings to American businesses would be enormous. Additionally, I don't believe that the complete elimination of the $ 100 dividend exclusion would make anyone either rich or poor.

Currently the recipient of a pension benefit may elect one of the following six (6) tax treatments, IRA rollover, Special 10-year Averaging, partial rollover, life time annuity, having it fully taxed or taxed at capital gain rates on pre 1974 contributions. I believe that this shopping list of tax treatments is extremely burdensome. Some of the methods reflect the improper tax treatment of pension benefits.

A pension is a wage continuation plan whose purpose is to provide a worker with an income after retirement and it should be treated as such for tax purposes. Pension benefits should either be paid out over the employees life expectancy and taxed at ordinary rates or, if the employee feels that he could better manage his pension funds he should be permitted to rollover the funds his employer has accummulated for him into an IRA with mandatory payments made over his life expectancy. These payments should be taxed at ordinary rates.

The computation required to determine if Social Security benefits are subject to tax should be eliminated. If it is necessary to tax Social Security benefits they should be taxed in a manner similar to other annuities. Benefits should only become taxable after a worker has received back what he has paid into the Social Security Fund. Social Security is nothing more than an annuity and should by treated as such.

Alimony deductions should be eliminated. An individuals tax liability shouldn't be effected by their decision to divorce. Divorce is a personal matter and should be treated as such without the government subsidizing it. Alimony deductions are perhaps one of the most litigated of all the deductions claimed by taxpayers and may continue to be so, not withstanding the "TRA" changes of 1984.

The Investment tax credit should be either 8 or 10 percent. Currently a taxpayer may elect a 10% investment credit, instead of the 8% credit, if he reduces the basis of the investment asset, for the purposes of depreciation, by 50% of the credit (taken). I fail to see what purpose this election serves. If there is some purpose served by this basis adjustment may I suggest that there be some threshold before a basis adjustment to the asset is required.

I believe that by a simple, step by step common sense approach we can simplify our tax laws without creating a state of utter confusion. I think that we all agree that change for the sake of change accomplishes nothing. We have seen the results of these types of changes in our schools.

I would like to call to the committees attention the fact that any tax simplification law that might be enacted will not simplify the way 1/3 of our nation currently files their tax returns. In 1982 95.3 million tax returns were filed. One third of these returns were filed on either Form 1040EZ or Form 1040A. In 1984 38% of all individual returns filed through April 30 were filed on form 1040EZ and 1040A. Of the 59.4 million taxpayers who filed their return on the long form in 1982, only 33.7 million claimed itemized deductions.

I would like to thank the committee for the opportunity to make my views known. If any member of the committee has any questions, I will be most happy to answer them.

Thank you.

Senator CHAFEE. I would like to ask Mr. Scheppach about the National Governors' Association. You make the point, point one in your testimony, that the States have a substantial stake in the Federal tax system. And in Federal tax reform. What about the argument in favor of stability in our policy? In other words, fewer major shifts. Would that be helpful to you? And would you perhaps seek a moratorium on tax changes?

Mr. SCHEPPACH. I think the big problem there, Mr. Chairman, is one of transition. When you passed the 1981 bill with the accelerated cost recovery changes, it was retroactive and that forced States to make a number of tax changes to offset their potential revenue loss.

I think if there is transition period of 2 to 3 years to make the changes, then I'm not sure that Governors would argue against any kind of reform. Some State legislatures only meet every 2 years. So if you make changes, that puts them in a difficult situation.

Senator CHAFEE. So what you are saying is if we are going to make changes, give them enough leadtime.

Mr. SCHEPPACH. Give them enough leadtime for a transition to make those changes.

Senator CHAFEE. And be careful about retroactivity.

Mr. SCHEPPACH. Very careful about that.

Senator CHAFEE. All right.

Mr. Hacking, you seem to favor the status quo for our tax system, basing it on ability to pay with certain incentives to achieve social and economic goals. But what about the apparent decling public support for the existing system? As was mentioned, you have heard some testimony about the growing underground economy. That probably to a considerable extent is based on the view that those who can hire a high powered lawyer are probably getting away from paying their fair share. And, thus, there is some disgruntlement abroad about the existing system.

Mr. HACKING. Well, Mr. Chairman, while AARP is very much committed to the ability to pay principal, I wouldn't say we are committed to the status quo. First, I made the point of saying that revenue needs to be raised. And we need to look at existing tax mechanisms as well as new ones for the purpose of deciding how much revenue should be raised, and which is the most appropriate instrument, deciding appropriateness on the basis of differential impacts on the economy as we expect the economy to be in 1985 and 1986.

There are also other related equity considerations that have to be taken into account. What I am saying is not let's maintain the status quo and not change anything. Quite the opposite. We agree with you. Public opinion polls indicate that the public, including the elderly, is very unhappy with the current income tax system because the tax base has been so badly eroded through the variety of special interests tax breaks that have been introduced and accumulated over the years.

One approach to making the income tax structure as we have it now more popular would be to review those tax expenditures and eliminate or scale back those that have outlived their economic usefulness.

But that is a long and difficult process. The Congress tried to do some of that this year without a great deal of success. Nevertheless, the effort, I think, was well worth it. You may have to do it again next year.

But we also think that some of these modified flat tax proposals could, in fact, be used as a substitute and still preserve a lot of the principles that AARP espouses, especially the ability to pay principle.

Senator **Chafee**. Let me ask you this. There has been a lot of discussion by those advocating a flat tax and tax simplicity that the personal exemption be substantially increased. Would it be AARP's view that that personal exemption, if it were, say, doubled, should also pertain to those—that same exemption apply to those over 65? In other words, the doubling of the exemption for the 65 and over.

Mr. **Hacking**. Well, there is a double exemption available to them now under current law. We would want to look at the specifics of any proposal and compare what would happen to the elderly under the current system as opposed to what would happen under any alternative. And that is one of the things that we are now in the process of gearing up to do. That's why we are not, at this time, specifically endorsing any particular proposal.

Senator **Chafee**. Do you get what my question is though?

Mr. **Hacking**. Yes, I understand your question.

Senator **Chafee**. The question is would that same exemption—let's say it went to $2,000 that an individual got. Would your feeling also be that that should be doubled for those over 65?

Mr. **Hacking**. Well, the double exemption is the principle we have under current law. But whether it should be retained would depend on what the other features are that make up the overall package, and what the net effect of that would be on elderly households.

Senator **Chafee**. Fine. Thank you all very much, gentlemen. We appreciate your testimony.

Senator **Chafee**. Now Dr. Fink, Mr. Perry, Mr. Rosenbaum, Mr. Graham, and Mr. Hopkins.

All right, gentlemen, why doesn't Dr. Fink start off?

STATEMENT OF RICHARD H. FINK, PRESIDENT, CITIZENS FOR A SOUND ECONOMY, WASHINGTON, DC

Mr. FINK. Thank you, Mr. Chairman, for this opportunity to describe to you my organization's views on tax reform and tax abatement.

My name is Richard H. Fink, president of Citizens for a Sound Economy. I'm also president of CSE's subsidiary, the National Taxpayers Legal Fund, which represents 36,000 taxpayers. I'm a research professor in economics at George Mason University in Fairfax, VA.

In the minutes that I have, I hope to accomplish two things. First, I would like to inject an important perspective into the committee's deliberations, a perspective that seems to be getting lost in the current debate. And, two, as is typical with college professors, I would like to recommend some readings that present the broader perspective in which the specific tax proposals must be analyzed.

The readings I refer to are contained in the anthology, I edited, called "Supply Side Economics, a Critical Appraisal." In particular, I recommend chapter 8, entitled "Economic Growth, Alternative Views." There are two articles in this section. One by Lester Thurow of MIT. One by Stanley Kaish, an economics professor at Rutgers and the Democratic mayor of Springfield, NJ.

What is unique about this section is that it represents three perspectives from three different schools of thought in economics. Despite the different approaches, each author acknowledges an important fact about economic growth. Namely, the level of savings, as well as the sectors of the economy to which these savings are channeled, is critically important to sustainable economic growth, the economic well-being of the citizenry and most critically, lower income families.

The perspective often ignored in the current debate is this: We must question the desirability of revenue neutrality before we change the Tax Code. Federal spending is analogous to consumption spending. Such spending does not fuel economic growth. What fuels economic growth is savings. What is needed for the economic well-being of the citizenry is to return resources to private sources for investment in the future. We can do this in three ways: Decrease taxes, decrease Government spending, and decrease the cost of Government interaction in the economy. This last can be done by simplifying the Tax Code and reducing the resource misallocation caused by the complexity of the code.

The present system extracts too many dollars from the hands of the citizens, jeopardizing individual savings and investment plans, which in turn increases our dependence on the Government. The present system is also too complicated. The cost of compliance is enormous because of the complexity and the progressivity of the system. It directs resources away from sectors that contribute to economic growth by specifying deductibility in certain areas.

The Government also diverts too much of the country's natural resources into consumption programs. This diversion rechannels these resources away from capital formation, and, hence, economic growth.

An appropriate flat tax program would go far to serve the goal of sustainable economic growth, if it has a low rate that reduces tax revenue and does not rely on tax neutrality.

A good flat-rate tax would increase individual savings and increase capital formation. It would also reduce the cost of adherence to the tax system, and reduce the misallocation of resources. For example, the Government will mandate the destruction of 1.2 billion lemons this year partially because of the tax preferences in lemon growing. We can examine almost every industrial sector of the economy and show how resources are misallocated because of tax preferences.

However, whatever tax reform is adopted, cuts in congressional programs and Government spending, whether on domestic or defense programs, are a necessary complement. My prepared statement explains some of these points in greater detail.

Thank you, Mr. Chairman.

Senator CHAFEE. All right. Thank you very much, Mr. Fink.

[The prepared written statement of Mr. Fink follows:]

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Washington, D.C. 20001

TESTIMONY OF

RICHARD H. FINK

September 20, 1984

Thank you, Mr. Chairman, for this opportunity to describe to you my organization's views on tax reform and tax abatement. My name is Richard H. Fink, President of Citizens for a Sound Economy. I am also President of CSE's subsidiary, National Taxpayers Legal Fund. I am a research professor in economics at George Mason University in Fairfax, Virginia.

As an economist and as president of CSE and NTLF, I am ~~extremely~~ concerned about the direction and tone which the debate over tax reform has taken. Too many participants in this debate have been operating under the illusion that serious tax reform should necessarily be revenue neutral, that is, that the current level of tax revenue should be maintained. Many argue that the current level of federal spending is proper and that the current administration has cut taxes.

I submit that neither of these arguments ~~are~~ is valid. The size of the federal budget continues to grow, albeit more slowly, both in real and nominal terms. The federal budget deficit has also grown significantly since 1980. ~~The fact is that~~ As government spending continues to grow, ~~and~~ the American taxpayer in general has ~~had~~ to foot the bill. The present recovery, while a good sign, is unsustainable if Congress and the Administration do not do something soon to ~~begin~~ mak~~ing~~e real spending and tax cuts.

CSE and NTLF believe that it is only in this context that meaningful debate on tax reform can be undertaken.

In short, we support tax reform, specifically flat rate taxes, to the extent it is part of a workable and coherent strategy to reduce taxes, thereby uniting taxpayers in a common effort to reduce the misallocation of resources caused by the current tax structure. We reject the assumption that the present level of government revenues is the appropriate basis for tax reform.

As an economist, I find the present income-tax system to be inefficient and distortionary.

No tax system can be totally "neutral," i.e., without any effect on the economic system whatsoever. But some systems produce more distortions than others, and, as a general rule-of-thumb, the more complex it is, the more distortions it induces. The present complex system of deductions has led consumers, investors, and entrepreneurs to allocate their resources in ways that would be wasteful in the absence of the special deductions and ~~which~~ they generate overall economic losses in the process. A flattened tax system with lower marginal rates would reduce economic uncertainty and reduce the resulting misallocation of resources caused by the proliferation of inefficient tax shelters.

Investment decisions should be made to meet consumer demand, not the requirements of a distortionary tax code. Additionally, enormous resources are currently consumed in legal fees, accountant's salaries, and Washington lobbying on behalf of such deductions.

The current steeply graduated tax schedule contributes greatly to the economic problems created by the present tax system. As most of my fellow economists like to point out, all action is on the margin. What that means in the case of taxes is that a wage-earner or investor decides whether to earn an additional dollar (the "marginal" dollar) on the basis of whether the benefits of that dollar exceed the costs of earning it (in business costs, transportation expenses, lost opportunities for leisure, or whatever). If the earner gets the whole dollar, then it is worthwhile to undergo costs (including foregone opportunities for leisure) of up to but not equaling or exceeding the equivalent of one dollar to get that dollar. The difference between the cost and the benefit is the earner's "net return." By taxing that dollar, the benefit is forced down: a "wedge" is introduced between the earned dollar and what the earner gets to keep. This wedge can make the real benefit approach the cost. When cost and benefit meet, the earner stops earning; the marginal dollar becomes ~~so~~ too costly to earn. At that point, the wage earner or investor will choose to allocate his or her time to leisure and resources to consumption. ~~And,~~ The greater the wedge (i.e., the higher the marginal tax rate), the lower the productivity level at which leisure and consumption become more attractive than work and investment.

High marginal tax rates are currently strangling economic activity that would otherwise take place. As Senator Bradley says, "lower rates stimulate work, savings, and investment...The broad general effect of lower tax rates will contribute to economic growth."

One of the more dubious assertions ~~which~~ that flat-rate tax detractors have put forth is the notion that such a reform would be favorable for the "haves" at the expense of the "have-nots." While it is true that some proposals represented as flat-tax proposals would do this, it is undeniable that the purer and lower flat-rate proposals will do exactly the opposite.

To illustrate my point, allow me to quote economist Friedrich Hayek, the Nobel Laureate, who has written that "the most serious consequence...is the restriction of competition. The system tends generally to favor corporate as against individual saving and particularly to strengthen the position of the established corporations against newcomers. It thus assists to create quasi-monopolistic situations. Because taxes today absorb the greater part of the newcomer's 'excessive' profits, he cannot, as has been well said, accumulate capital; he cannot expand his own business; he will never become big business and a match for the vested interests. The old firms do not need to fear his competition; they are sheltered by the tax collector."

Because of the current graduated system, it becomes progressively more difficult for those on the lower rungs of the economic ladder to climb up.

In the present context, our case becomes even stronger. The Center on Budget and Policy Priorities has produced a report entitled "Inequity and Decline," that shows that while the 1981 Kemp-Roth tax rate reductions led to nominal tax cuts for those with income over $30,000 per year, the offsetting effect of inflation, bracket creep, and increased Social Security taxes actually caused nominal tax increases for those below the $30,000 a year level.

The lesson from this is clear: with an unindexed graduated tax system, the government officials have a huge incentive to inflate. The hard-fought battle for income tax indexing, scheduled to take effect next year, has had to be fought several more times since 1981. These battles expose the fact that a graduated system pits those in one income tax bracket against another. With a single flat-rate, the "need" for indexation would disappear, as inflation could not cause bracket creep.

Historically, we find that the bracket creep phenomenon has been significant. The income tax passed by Congress in 1913 as part of an "Act to Reduce Duties" had a maximum rate of 7 percent and was expected to be paid from the "excess" income of very wealthy people. It was not a tax levied on the working class. A rate of 2 percent was assessed on incomes of $20,000 to $50,000, gradually increasing to a 7 percent marginal rate on $500,000 or more.

When the Second World War served to excuse raising maximum rates as high as 94 percent, still only a very few paid these confiscatory rates. In 1947, 80 percent of the families in the U.S. had an annual income of less than $5,000. The effective tax rate was about 8.4 percent. For these Americans taxes had doubled between 1939 and 1941 and doubled again between 1941 and 1947. Even so a worker making $5,000, who was married and had two children, paid around $420 in income tax plus $30 in social security taxes. He faced a marginal tax rate of less than 20 percent. Only 2.8 percent of the families in America had incomes greater than $20,000, which then carried a 56 percent marginal rate.

Today's dollar is worth only about one-fourth of the 1947 dollar, but the point is that in 1947, after the biggest war in history, few people were in high marginal tax brackets.

As a result of inflation and economic growth, today 80 percent of the families in the U.S. have incomes over $10,000, and 50 percent make more than $20,000. In other words, the average worker is facing tax rates intended originally only for the "rich." Additionally, maximum employee social security "contributions" have risen from a mere $30 annually in 1947 to $2,170 in 1982, a phenomenal 7,233 percent increase in this tax. For the first twenty years of social security, from 1937 to 1956, nobody contributed more in a year than today's worker is expected to pay every other week.

Besides pure economic theory, the case for a flat-rate tax can be made on the grounds that it simplifies the current system.

The present tax code runs approximately 2,000 pages of dense text. Most taxpayers can't even begin to understand the tangled system that has emerged through nearly seven decades of Congressional adjustments and amendments, and this may be one factor behind the large numbers of non-filers. A tax system too complex to understand invites arbitrary interpretation by government agents and unequal treatment for taxpayers. Many Americans are tired of hiring others to do their taxes and of making many financial decisions in response to obscure provisions of the tax code.

The current complex tax code is not without real economic costs. NTLF has issued a study which shows that the Internal Revenue Service's (IRS) budget has grown dramatically since 1958. In that year, their budget was more than $337 million. Their 1983 budget stood at over $3 billion, a 901 percent nominal increase and a 265 percent real increase. With a flat-rate tax, with few tax preferences, the "need" for the IRS's broad powers for monitoring and collecting taxes would be minimized as the tax system was simplified.

If Congress is not convinced by the overwhelming economic case for the flat-rate tax, perhaps the pure political case will convince them. A Harris survey has found that the American people favor a flat-rate tax by a 62 to 25 percent margin. It is bad politics, in my estimation, to oppose the flat-rate tax. As the forms become more complex and the tax bills become larger and larger, the American taxpayers' frustration with the system grows. The time has come where Congress must come to grips with a problem ~~which~~ that will not go away.

Thank you, Mr. Chairman, for this opportunity for me to articulate CSE's and NTLF's position on fundamental tax reform.

STATEMENT OF JOHN H. PERRY, JR., CHAIRMAN, AMERICANS FOR THE NATIONAL DIVIDEND ACT, ROSSLYN, VA

Senator CHAFEE. Mr. Perry.

Mr. PERRY. Mr. Chairman, my name is John H. Perry, Jr., and I am a businessman. I am also the chairman of Americans for the National Dividend Act, which is a proposed tax policy which is both fair and simple. It has been introduced in the current session of Congress as H.R. 5085, and its 35 cosponsors are as representative of the political and social diversity of this Nation as possible.

While the national dividend plan would not address personal income taxes, it will create the most favorable possible economic conditions for a fair and equitable application of taxes.

Mr. Chairman, I would like to summarize the elements of the national dividend plan at this time. I have provided for the record more detailed information, including a copy of the bill, H.R 5085.

There are five reforms at the heart of the National Dividend Act now pending before Congress in the Ways and Means Committee. One, the national profitsharing. The central innovation of the plan is the creation of the national dividend trust fund. All Federal corporate income tax collections would be placed in this trust. Instead of being spent as part of the government budget, the fund would be distributed in quarterly dividends to all registered voters, so long as the Federal deficit did not exceed the amount in the trust. Dividend payments would increase as corporate productivity increased.

Funds would be distributed through local banks using local voter registration lists. Banks would be compensated for the expenses involved by serving as interest free depositories for specific short periods of time.

While the dividend payments would be exempt from Federal taxes, they would be subject to State and local taxes at the discretion of State and local governments. This additional revenue would enable States and cities to operate with no new taxes. Because only registered voters would receive dividend payments, the plan would increase participation in the voting process.

Two, discouraging budget deficits.

Senator CHAFEE. Would everybody get the same amount?

Mr. PERRY. Everybody gets the same amount. That makes it easy and costless to administer.

Total funds available for the national dividend would be reduced each year by any Federal budget deficit. This feature is called the automatic dividend deduction. The ADD provision of the national dividend plan gives every voter a vested self-interest reason for resisting Federal deficits. A Federal deficit would become a major political liability to a Member of Congress because that Member would be held directly responsible for the reduction or absence of his constituents' dividend checks.

Three, eliminate double taxation of dividends. Corporate profits presently are taxed twice by the Federal Government. First at the corporate level and again in the individual level when distributed to shareholders as dividends. Such a tax creates a disincentive to invest. The national dividend plan would end the Federal personal income tax on corporate dividends. This would attract investment dollars into the private sector. Thus, creating new jobs and stimulating economic growth.

Four, a cap on corporate tax rates. The national dividend plan addresses the issue of placing a ceiling on the Federal corporate income tax rate. This plan is flexible on the level at which the cap would be established. However, it suggests that the rate should not exceed 46 percent, the present rate.

Placing a statutory ceiling on tax rates is a necessary check against the self-interest of voters whose dividends in the short run would increase in direct relation to an increase in the corporate tax rate.

Five, control Government expansion. The national dividend plan would be phased in over a 5-year period. To prevent disruption of existing Federal programs during this time, a moratorium would be placed on new Federal spending programs. The moratorium would permit revenues, increasing from normal economic growth, to catch up with current spending levels without threatening existing Government services. In the first year, one-fifth of all corporate income taxes would be paid into the trust fund. In the second year, two-fifths, and so on. In the fifth year, the program would be fully operational.

The plan requires no new taxes and would be funded entirely by earned dollars as opposed to tax or deficit dollars. No additional layer of bureaucracy would be required to administer the plan since all money would be distributed through private banks.

Most important of all, the national dividend plan would guarantee a majority constituency against excessive Government spending, and would reward the productivity of the American people.

We believe the national dividend plan is unique in that it will treat the entire electorate in the same unbiased way. It will provide the incentive for the electorate to permit Congress to take the necessary and unprecedented step to cap spending until revenues catch up.

The H.R. 5085 does five things. It redistributes income. It eliminates Federal deficits and helps reduce inflation and interest rates. It does not require tax increases. It does not cut social programs, but it encourages the producers to work for the benefit of us all.

Every day the Congress delays passing H.R. 5085 it costs the Federal Government $500 million.

I thank you.

Senator CHAFEE. Thank you very much.

Senator SYMMS. Do you have a copy of that bill?

Mr. PERRY. I will give you the whole thing right here.

[The prepared written statement of Mr. Perry follows:]

TESTIMONY OF JOHN H. PERRY, Jr.
TO THE
COMMITTEE ON FINANCE
THE UNITED STATES SENATE
THURSDAY, SEPTEMBER 20, 1984

My name is John H. Perry, Jr. and I am a businessman. I am also Chairman of Americans for the National Dividend Act. I am presenting a proposed tax policy that is both simple and fair.

What I offer today is certainly an idea whose time has come. I refer to the National Dividend Plan. This plan has withstood the careful analysis and scrutiny of professionals in academics, finance, economics, banking, the social sciences and politics to name but a few. I have spent many years and millions of dollars in a careful and detailed analysis of this proposal before I offered it in legislative form. It has been introduced in the current session of Congress as H.R. 5085 and its thirty five (35) cosponsors are as representative of the political and social diversity of this nation as possible.

While the National Dividend Plan would not address personal income taxes, it will create the most favorable possible economic conditions for a fair and equitable application of taxes.

Mr. Chairman, I would like to summarize the elements of the National Dividend Plan at this time. I have provided for the record more detailed information including a copy of the bill, H.R. 5085.

Creating A Constituency for Real Economic Growth

The National Dividend Plan is a comprehensive economic proposal to revitalize the most powerful economic machine in history - the American Economy - and to allow all of our citizens to participate and benefit from this success. The plan accomplishes this by instituting five related reforms that will encourage participation in the private sector and assure a balanced federal budget.

Those five reforms are the heart of the National Dividend Act, H.R. 5085, now pending before Congress.

I. NATIONAL PROFIT SHARING - The central innovation of the Plan is the creation of the National Dividend Trust Fund. All federal corporate income tax collections would be placed in this Trust. Instead of being spent as part of the government budget, the fund would be distributed in quarterly dividends to all registered voters - so long as the federal deficit did not exceed the amount in the Trust. Dividend payments would increase as corporate productivity increased.

Funds would be distributed through local banks using local voter registration lists. Banks would be compensated for the expenses involved by serving as interest-free depositories for specified short periods of time.

While the dividend payments would be exempt from federal taxes, they could be subject to state and local taxes (at the discretion of state and local governments). This additional revenue could enable states and cities to operate with no new taxes.

Because only registered voters would receive dividend payments, the Plan would increase participation in the voting process.

II. Discouraging Budget Deficits - Total funds available for the National Dividend would be reduced each year by any federal budget deficit. This feature is called the Automatic Dividend Deduction (ADD). The ADD provision of the National Dividend Plan gives every voter a vested, self-interest reason for resisting federal deficits. A federal deficit would become a major political liability to a member of Congress, because that member would be held directly responsible for the reduction or absence of his constituents' dividend checks.

III. Eliminate Double Taxation of Dividends - Corporate profits presently are taxed twice by the federal government, first at the corporate level and again on the individual level when distriuted to shareholders as dividends. Such a tax creates a disincentive to invest.

The National Dividend Plan would end federal personal income tax on corporate dividends. This would attract investment dollars into the private sector, thus creating new jobs and stimulating economic growth.

IV. A Cap on Corporate Tax Rates - The National Dividend Plan addresses the issue of placing a ceiling on the federal corporate income tax rate. The plan is flexible on the level at which the cap would established. However, it suggests that the rate should not exceed 46 percent, the current rate.

Placing a statutory ceiling on tax rates is a necessary check against the "self-interest" of voters whose dividends, in the short run, would increase in direct relation to an increase in the corporate tax rate.

V. Control Government Expansion - The National Dividend Plan would be phased in over a five year period. To prevent disruption of existing federal programs during this time, a moratorium would be placed on new federal spending programs. The moratorium would permit revenues, increasing from normal economic growth, to catch up with current spending levels without threatening existing government services.

In the first year, one-fifth of all corporate income taxes would be paid into the Trust Fund. In the second year, two-fifths, and so on. In the fifth year the program would be fully operational.

The Plan requires no new taxes and would be funded entirely by earned dollars, as opposed to tax or deficit dollars. No additional layer of bureaucracy would be required to administer the Plan, since all money would be distributed through private banks.

Most important of all, the National Dividend Plan would guarantee a majority constituency against excessive government spending and would reward productivity of the American people.

The NDP is a recognition of the fact that this country's economic problems are not caused by flaws in the science of economics. They are the unquestionable result of our political system which weighs the Political impact among varied interest groups of this nation to laws pertaining to our methods of financing government.

We believe the National Dividend Plan is unique in that it will treat the entire electorate in the same unbiased way. It will provide the incentive for the electorate to permit Congress to take the necessary (and unprecedented) steps to cap spending until revenues catch up.

Mr. Chairman, each day that we delay passage of H.R. 5085 it costs the taxpayers 1/2 billion dollars in Federal deficits.

Thank you for the opportunity to appear.

Americans for the National Dividend Act, Inc.
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Rosslyn, Virginia 22209
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Gen. Wm. C. Westmoreland (U.S. Army, Ret.)
Chairman, Advisory Board

John H. Perry, Jr.
Chairman

September 17, 1984

Hon. Robert Dole
Chairman, Senate Finance
Committee
141 Hart Building
Washington, D.C. 20510

Dear Bob:

In view of the current dilemma of whether or not to raise taxes, I thought it might be appropriate to call your attention to some recent press comments on H.R. 5085 -- The National Dividend Act. The attached AP column by John Cunniff does an excellent and succinct job of explaining the Act's advantages and also there is attached some editorial opinion on the subject.

As you know, there are now 35 sponsors on the bill, representing a very broad spectrum of House support to get the budget under control. Fourteen of the sponsors are on the Ways and Means Committee.

I suspect that the Administration is considering seeking a fundamental change in our tax system after the election. But in view of the complexity of our present tax system built up over decades with its carry-forwards and carry-backs and the rights of our citizens to challenge the Constitutionality of any of the provisions, including such issues as fairness and protection of property rights, I do not believe that it is possible to make a fundamental change in the way our taxes are collected. It is much easier to change the way we spend the money than it is to change the way we collect the money.

Some ideas may sound good but the minute that you examine them, they fall apart -- not necessarily because they are not good ideas, but because politically it is not feasible to make a drastic change.

On the other hand, H.R. 5085 does not attempt to tamper with the basic system. It merely changes the way the system pays out some of the tax collections and in a manner that is simple and one that increases incentives. In addition, it provides an answer to the fairness issue. The only change it makes in the collection part of the system is one which merely eliminates several hundred tax code provisions.

Finally, most all of the new proposals fail to address themselves to the basic flaw that is causing all the fuss in the first place, i.e., excessive government spending and its role in the economy. None of them prevent the excesses and abuses which have caused the problem. They address themselves to the problem of raising more money faster so as to cure the twin demons of debt and deficit. If one or the other of the proposed systems were in effect, the old "tax, tax, spend, spend, elect, elect" syndrome would still be at work but more guilty than ever because it would then be so easy to solve the shortages by merely raising the percentages.

We dare not forget a fundamental requirement -- we need earnings in real dollars to pay for the transfer payments, the entitlements, the "bread and circuses" or else we are going down the same old route that has been responsible for the collapse of so many preceding civilizations -- never in the history of the entire world has a solution to this problem been more important and urgently needed.

The time is ripe to have this concept given serious consideration. The voters will be overwhelmingly behind you since money that formerly was used to build up the bureaucrats' power will now be going directly to them. This plan will not require a Constitutional Amendment but will accomplish the same end result with added political dividends.

EVERY DAY that the Congress delays in passing H.R. 5085, it costs the federal government ONE-HALF BILLION DOLLARS, because that is the current daily cost of our annual deficits. The National Dividend Act would stop the deficits because the voters would insist on it, so that they could receive their National Dividends.

I remain,

Sincerely yours,

John H. Perry, Jr.

THE CAUSES

How did we get into this financial problem? Using a policy of stimulating the economy through demand-side economics, we took on more federal programs than we could afford. Then supply-side economics was introduced to cut inflation. But when we reduced inflation, we also reduced income tax bracket creep and this choked off federal revenues. In addition, increases in military spending, and indexing of welfare and Social Security put the federal budget even more out of control, paving the way for more debt and deficits.

HOW TO GET THE FEDERAL BUDGET UNDER CONTROL

THE SOLUTION

We need a politically feasible way to curb the forces which cause the federal budget to remain in deficit.

We must separate the management of the debt from management of the humanely motivated social programs of the last half century before they fall victim to a massive financial crunch.

We must have both supply-side and demand-side economics.

H.R. 5085 (The National Dividend Act) is a major step in the right direction because it:

Provision 1. Imposes a moratorium on any federal budget increases.

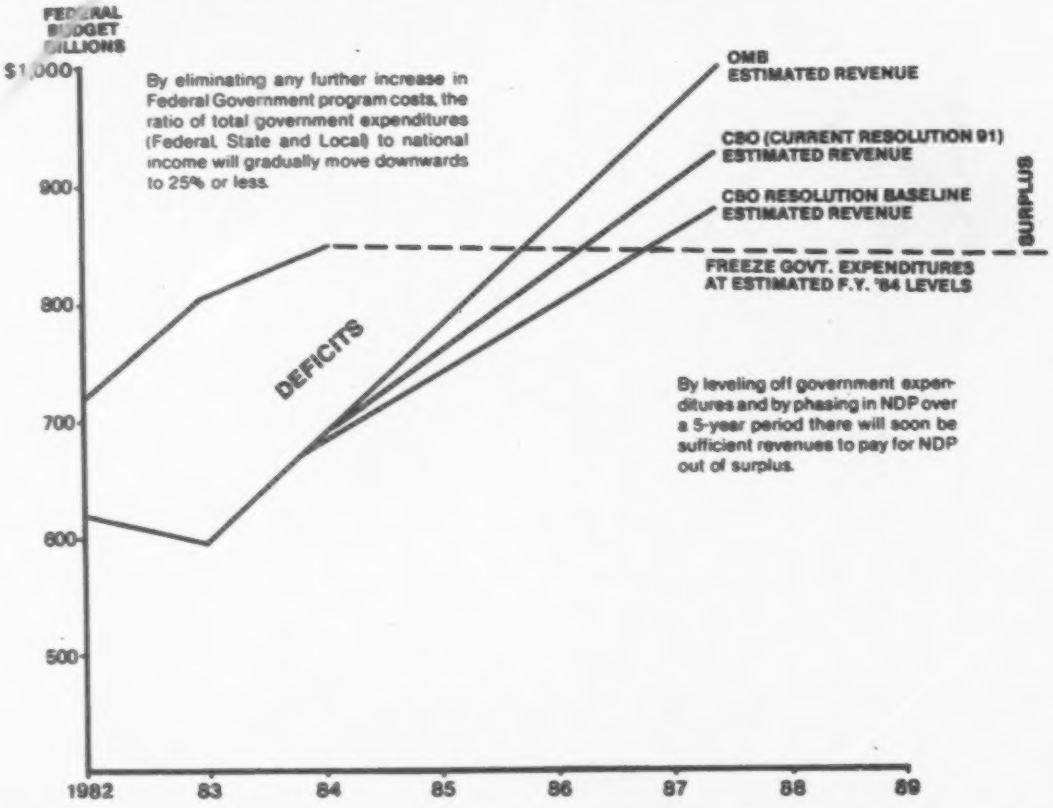
Provision 2. Imposes a maximum rate on the federal corporate income tax at the present 46 percent.

Provision 3. Ends the present double tax on dividends.

Provision 4. Establishes a trust fund of all corporate income tax revenues collected by the federal government each year and provides for its distribution on a per capita basis to all registered voters in the nation.

Provision 5. Provides that the total amount of the trust fund to be paid out would be reduced by the amount of any federal budget deficit.

HOW PROVISIONS OF THE NATIONAL DIVIDEND PLAN WOULD PUT THE FEDERAL BUDGET INTO SURPLUS



By eliminating any further increase in Federal Government program costs, the ratio of total government expenditures (Federal, State and Local) to national income will gradually move downwards to 25% or less.

By leveling off government expenditures and by phasing in NDP over a 5-year period there will soon be sufficient revenues to pay for NDP out of surplus.

FISCAL POLICY COUNCIL, 100 E. 17TH ST., RIVIERA BEACH, FLORIDA 33404

Provision No. 2

WHY A MAXIMUM CORPORATE INCOME TAX RATE OF 46%

1. It provides investors assurance that corporate income tax rates will not discourage investment.

2. By holding the maximum corporate tax rate at 46% we can prevent taxes from exceeding the law of diminishing returns and thereby get the most revenues for distribution to registered voters and to the stockholders.

3. It will enable business executives to plan capital outlays for expansion and new ventures without worrying about an unexpected increase in the corporate income tax rate.

Provision No. 3

WHY MAKE DIVIDENDS TAX-FREE?

Ending the present double tax on corporate earnings will:

Encourage savings and provide new incentives for investment, keeping this money in the productive private sector.

Encourage business proprietors and management to make business decisions instead of tax decisions.

Simplify tax law by eliminating 51 sections of the present code.

Provision No. 4

WHY DISTRIBUTE CORPORATE INCOME TAXES TO VOTERS?

Distribution of federal corporate income tax revenues on an equal share basis to the nation's registered voters each year:

1. Will put $80-$100 billion in real, earned dollars back into consumer purchasing power, providing a stable demand in the marketplace for the production and consumption of goods in the job-creating, private sector of the economy.

2. Will be accomplished with no administrative cost to the federal government.

3. Will involve distribution of real dollars and will provide economic stimulation without creating the inflationary pressures resulting from outlays of tax-added dollars.

4. By building a political constituency with the registered voter, we can encourage the Congress to be more in favor of profits, less waste, less caving-in to special interests, and above all, a recognition that we must have a sound, stable economy if we are to restore prosperity.

Provision No. 5

WHY DEDUCT BUDGET DEFICITS
FROM THE
NATIONAL DIVIDEND TRUST FUND?

Deducting federal budget deficits from the trust fund before distribution to the registered voters will:

Ensure an early end to deficits by involving the voters on a personal basis with the budget process. Voters will insist on surpluses out of which they can receive their national dividend check.

H.R. 5085 will shrink the relative size of the federal government so that the total tax burden, relative to our ability to pay for it, is reduced permanently to a non-inflationary level.

A NEW DOCTRINE

H.R. 5085 offers the American voters a quid pro quo: A share in the nation's profits in exchange for a cap on federal expenses for the next five years. Having the voters as part of the capitalistic system will do more to reduce unemployment than any other factor. By encouraging both demand and supply economics for the benefit of the general welfare, we no longer will have to cut back on government spending or use other methods to reduce inflation at the expense of increased unemployment.

Necessary constituency support will be generated through the National Dividend Act because American voters can get more benefits in the long run from their dividends, from a stable economy and from the knowledge that they are getting their fair share of what is available from corporate profits. It must become obvious to them that no one is entitled to any funds that have not been earned.

In some [illegible] ways, our well-meaning policies of the past have attempted the philosophy of, "To each according to his need...," a policy which has committed us to more humanitarian programs than we can afford and thus jeopardized our free economic system. But, as a free society, we have always found the strength and wisdom to work our way out of the dilemmas and achieve even greater heights.

We believe that in our democratically based, capitalist society, our doctrine must be, "To each according to our free society's ability to pay and to encourage the producers to work for the benefit of us all." Getting the budget back under control is the necessary first step toward achieving that ability.

ANDA, Inc.

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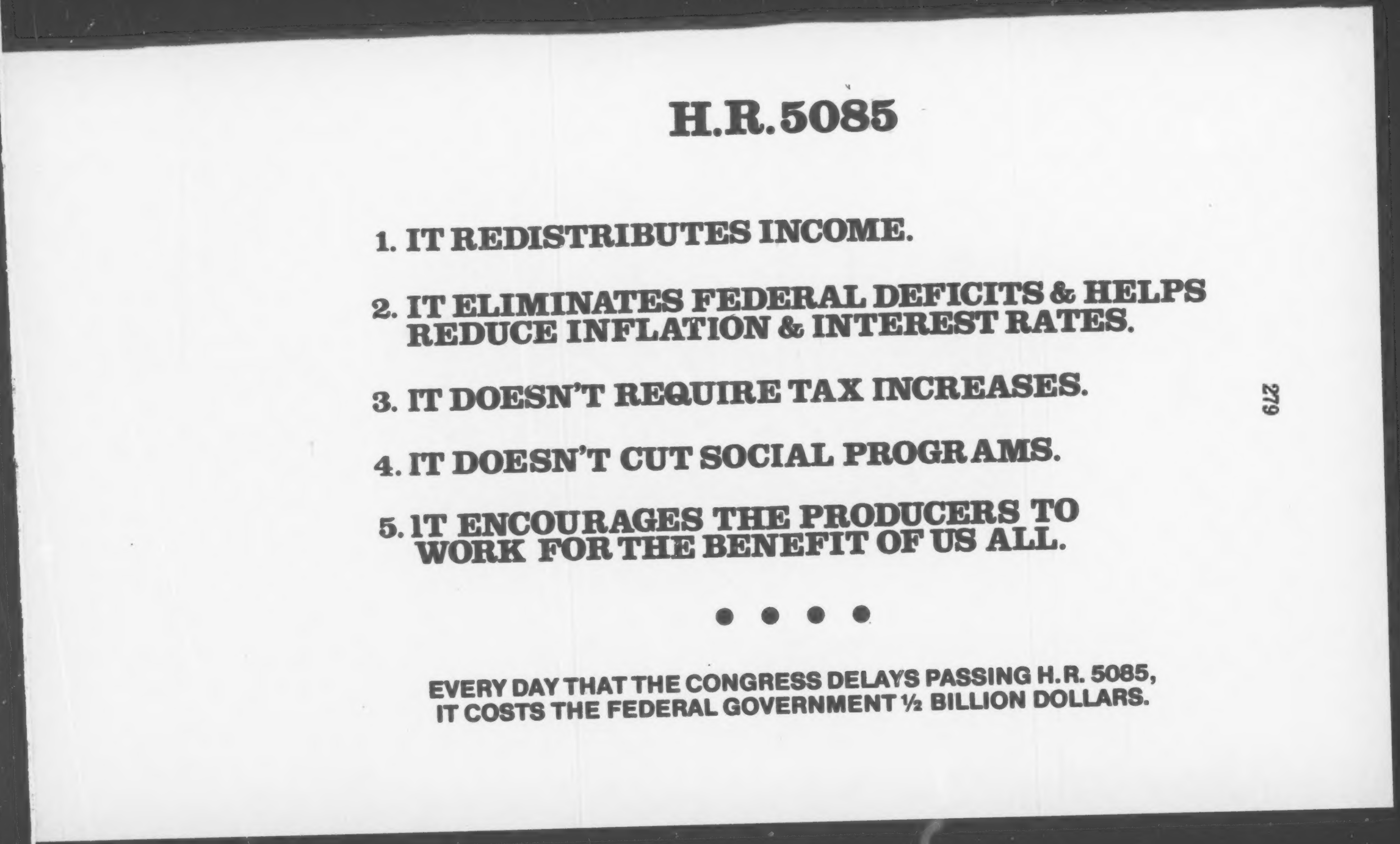
September 1984



H.R. 5085

1. IT REDISTRIBUTES INCOME.
2. IT ELIMINATES FEDERAL DEFICITS & HELPS REDUCE INFLATION & INTEREST RATES.
3. IT DOESN'T REQUIRE TAX INCREASES.
4. IT DOESN'T CUT SOCIAL PROGRAMS.
5. IT ENCOURAGES THE PRODUCERS TO WORK FOR THE BENEFIT OF US ALL.

● ● ● ●

EVERY DAY THAT THE CONGRESS DELAYS PASSING H.R. 5085,
IT COSTS THE FEDERAL GOVERNMENT ½ BILLION DOLLARS.

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Chairman, Advisory Board

John H. Perry, Jr.
Chairman

H.R. 5085
(98th Congress, 2nd Session)
THE NATIONAL DIVIDEND ACT OF 1984

This act has 5 interrelated provisions:

1. All the federal corporate income tax collections would be put into a national profit sharing trust fund to be distributed on a per capita basis to all U.S. registered voters. This would amount to somewhere between $700 and $1000 per annum depending on how many voters register and how much corporations earn. The reason for this is obvious: The voters will now be for more corporate profits rather than less. The result will be an enormous increase in the general understanding of what profits really are and a marked lessening of demagogic attacks on the system which has been responsible for making our country so successful.

2. In order to put an end to further federal deficits and to halt the rise in the federal debt there would be no national dividend payments unless there was a surplus from which to pay the dividend. Voters would insist on a surplus and Congress would soon get the message.

3. In order to insure that there is a surplus there would be a 5 year freeze in federal spending at the present level. Growth revenues thus would put us in surplus in approximately 2½ years (see chart).

4. In order to insure that there would be maximum incentive for profitable productivity, the double tax on dividends would be eliminated. This would have many beneficial effects on improving business efficiency, eliminating about 300 provisions of the tax code and reversing the present imbalance between return on risk equity and interest on bond indebtedness which has kept this nation's savings far below levels necessary to prevent inflation and to keep interest rates down. Business managers would start making business decisions instead of tax decisions.

5. In order to insure that federal corporate taxing would not go beyond the point of diminishing returns there would be a ceiling at the present 46% maximum rate. This would insure maximum revenue for both the registered voter and the corporate stockholder whose ownership rights would now be greatly strengthened.

98TH CONGRESS
2D SESSION

H. R. 5085

To amend the Internal Revenue Code of 1954 to eliminate the double tax on dividends, to allocate corporate income tax revenues for payments to qualified registered voters, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

MARCH 8, 1984

Mr. ALEXANDER (for himself, Mr. MARTIN of North Carolina, Mr. VANDER JAGT, Mr. MOORE, Mr. SCHULZE, Mr. FLIPPO, Mr. NELSON of Florida, Mr. HANCE, Mr. FOWLER, Mr. JENKINS, Mr. SHUSTER, Mr. HEFNER, Mr. ANTHONY, Mr. FORD of Tennessee, Mr. GRAY, Mr. SPENCE, Mr. DUNCAN, Mr. QUILLEN, Mr. JONES of North Carolina, Mr. ROEMER, Mr. MITCHELL, Mr. CAMPBELL, Mr. YOUNG of Alaska, Mr. DOWDY of Mississippi, Mr. BONER of Tennessee, Mr. PHILIP M. CRANE, Mr. MONTGOMERY, Mr. DARDEN, Mr. DANIEL B. CRANE, Mr. ROWLAND, Mr. HARTNETT, and Mr. DORGAN) introduced the following bill; which was referred to the Committee on Ways and Means

In addition: Newt Gingrich (R-Ga.); Bob Stump (R-Ariz.); Sam B. Hall, Jr. (D-Tex.)

A BILL

To amend the Internal Revenue Code of 1954 to eliminate the double tax on dividends, to allocate corporate income tax revenues for payments to qualified registered voters, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "National Dividend Act of 1984".

SEC. 2. NATIONAL DIVIDEND PAYMENT TO REGISTERED VOTERS.

(a) PAYMENTS FOR DISBURSEMENTS TO REGISTERED VOTERS OF EACH STATE.—

(1) IN GENERAL.—The Secretary of the Treasury shall pay during each calendar year after 1984 to the chief financial officer of each State an amount equal to the national dividend payment for the immediately preceding calendar year multiplied by the number (provided to the Secretary by such officer) of individuals who are qualified registered voters of such State for such preceding year.

(2) SEMIANNUAL INSTALLMENTS.—One-half of the amount payable under paragraph (1) to the chief financial officer of any State during calendar years 1985, 1986, and 1987 shall be paid to such officer at the beginning of the second and fourth calendar quarters of such year.

(3) QUARTERLY INSTALLMENTS.—One-fourth of the amount payable under paragraph (1) to the chief financial officer of any State during any calendar year after calendar year 1987 shall be paid to such officer at the beginning of each calendar quarter of such year.

(b) AMOUNT OF NATIONAL DIVIDEND PAYMENT.—The national dividend payment for any calendar year shall be an amount equal to—

(1) the excess of—

(A) the sum of (i) the aggregate amount transferred under section 3(b)(3) to the National Dividend Payment Trust Fund during the fiscal year ending during such calendar year plus (ii) any interest credited during such fiscal year to the Trust Fund under section 3(c)(2)(B)(iii); over

(B) the sum of (i) the amount transferred out of the Trust Fund during such fiscal year under section 3(b)(4) plus (ii) the deficit adjustment amount calculated pursuant to section 6(a) of this Act; divided by

(2) the number of individuals who are qualified registered voters for such calendar year, on the basis of reports submitted, not later than November 30 of such calendar year, to the Secretary (in such manner as the Secretary may by regulations prescribe) by the chief financial officer of each State.

(c) METHOD OF DISBURSEMENTS TO QUALIFIED REGISTERED VOTERS.—

(1) IN GENERAL.—The national dividend payment for any calendar year shall be paid to each qualified

registered voter of a State by an incorporated bank which is selected (in accordance with paragraph (2)) for such year by the chief financial officer of such State as the disbursing agent of such State.

(2) SELECTION OF DISBURSING AGENT.—Any incorporated bank may be selected as the disbursing agent of any State under paragraph (1) by the chief financial officer of such State if—

(A) such bank is operating within such State, as determined by such officer;

(B) such bank submits a sealed bid to such officer in which such bank—

(i) specifies an amount which it agrees to pay such State as consideration for each year for which it pays national dividend payments to qualified registered voters of such State;

(ii) specifies procedures it agrees to follow in making such payments; and

(iii) agrees to limit the investment of any funds received for the purpose of making such payments to interest-bearing obligations of the United States or to obligations guaranteed as to both principal and interest by the United States; and

(C) such officer approves such bid, taking into consideration with respect to all such bids—

(i) the amount of such consideration;

(ii) any previous experience of such bank in making such payments; and

(iii) the ability and reliability of such bank to make such payments.

(3) TRANSFER OF FUNDS TO DISBURSING AGENT.—Funds received under subsection (a) by the chief financial officer of any State shall be transferred by such officer to the disbursing agent for such State not less than 10 days after the date such officer receives such funds.

(4) PAYMENT BY DISBURSING AGENT.—A national dividend payment shall be paid by the disbursing agent of each State to each qualified registered voter of such State who is included on a list provided to such agent by the chief financial officer of such State. Such payment shall be in the form of a negotiable instrument—

(A) which is drawn on an account of such agent;

(B) which is made payable to such voter; and

(C) which states, on the endorsement side of such instrument, that—

(i) such instrument must be negotiated within the 90-day period which begins on the date such instrument is drawn;

(ii) each qualified registered voter is entitled to only 1 national dividend payment for each calendar year; and

(iii) any individual who negotiates any such instrument and who is not entitled to the payment made by such instrument is subject under Federal law to fine, or imprisonment, or both.

(5) NATIONAL DIVIDEND PAYMENT INSTALLMENTS.—

(A) SEMIANNUAL INSTALLMENTS.—One-half of the amount of the national dividend payment payable during calendar years 1985, 1986, and 1987 to any qualified registered voter shall be paid to such voter at the close of the second and fourth calendar quarters of such year.

(B) QUARTERLY INSTALLMENTS.—One-fourth of the national dividend payment payable to any qualified registered voter during any calendar year after 1987 shall be paid to such voter at the close of each calendar quarter of such year.

(d) QUALIFIED REGISTERED VOTER.—

(1) IN GENERAL.—For purposes of this section, an individual is a qualified registered voter for any calendar year if—

(A) such individual was entitled to vote in the most recent Federal election before such calendar year; and

(B) such individual certifies to the State or local authority which supervises the voting of such individual that, during such calendar year, he complies with all conditions of his entitlement to vote.

(2) REGISTERED VOTERS.—In the case of any individual who in any calendar year registers to vote under State or local law, such registration shall be treated as complying with the certification under paragraph (1)(B) for such year.

(e) APPLICATIONS PERMITTED.—

(1) IN GENERAL.—The chief financial officer of each State may require individuals to apply to receive any national dividend payment under this Act.

(2) CRIMINAL PENALTY.—Any person who knowingly makes any false statement or representation of a material fact in any application submitted pursuant to paragraph (1) or in any certification under subsection (d) shall be fined not more than $10,000, or imprisoned

not more than 10 years, or both for each such false statement or representation.

(f) Payments To Be Made From National Dividend Payment Trust Fund.—Amounts in the National Dividend Payment Trust Fund shall be available, to such extent and in such amounts as are provided in appropriation Acts, for making the payments under this section.

SEC. 3. ESTABLISHMENT OF NATIONAL DIVIDEND PAYMENT TRUST FUND.

(a) Creation of Trust Fund.—There is hereby established in the Treasury of the United States a trust fund to be known as the National Dividend Payment Trust Fund.

(b) Transfer of Amounts Equivalent to Corporate Income Taxes to the Trust Fund.—

(1) In general.—There are hereby authorized to be appropriated to the Trust Fund amounts determined by the Secretary to be equivalent to amounts received in the Treasury, in fiscal years beginning after September 30, 1984, from the following taxes:

(A) the taxes imposed by sections 11 and 1201(a) of the Internal Revenue Code of 1954; and

(B) the taxes under subchapter L of chapter 1 of such Code.

(2) TRANSITION RULE.—Notwithstanding paragraph (1), in the case of a fiscal year beginning before October 1, 1988 the amount authorized to be appropriated to the Trust Fund for such year shall be the following percentage of the amount determined under paragraph (1)—

(A) 20 percent in the case of the fiscal year beginning October 1, 1984;

(B) 40 percent in the case of the fiscal year beginning October 1, 1985;

(C) 60 percent in the case of the fiscal year beginning October 1, 1986; and

(D) 80 percent in the case of the fiscal year beginning October 1, 1987.

(3) METHOD OF TRANSFER.—The amounts appropriated pursuant to this subsection shall be transferred at least quarterly from the general fund of the Treasury to the Trust Fund on the basis of estimates made by the Secretary of the amounts referred to in paragraph (1) (as modified by paragraph (2)). Proper adjustment shall be made in the amounts subsequently transferred to the extent such estimates are in excess of or less than the amounts required to be transferred.

(4) TRANSFER FROM TRUST FUND FOR ADMINISTRATIVE EXPENSES.—The Secretary may from time to time transfer from the Trust Fund—

(A) to the general fund of the Treasury the amount estimated by him as the costs incurred by the Department of the Treasury in the administration of section 2, and

(B) to the Board the amount estimated by the Board as its costs in carrying out its duties under this Act.

Proper adjustment shall be made in the amounts subsequently transferred to the extent such estimates are in excess of or less than the amounts required to be transferred.

(c) TRUST FUND BOARD.—

(1) IN GENERAL.—There is hereby established a review board to be known as the "National Dividend Review Board" which shall consist of 5 members appointed by the President, by and with the advice and consent of the Senate, from among individuals who are not officers or employees of the Federal Government.

(2) DUTIES.—

(A) REPORT.—It shall be the duty of the Board to review the manner in which payments under section 2 are made, to hold the Trust Fund, and to report to the Congress each year on such review and on the financial condition and the results of the operations of the Trust Fund during the preceding fiscal year and on its expected condition and operation during the next 5 fiscal years. Such report shall be printed as a House document of the session of the Congress to which the report is made.

(B) INVESTMENT.—

(i) IN GENERAL.—The Board may invest any amount of the Trust Fund which the Board determines is not required to meet current payments from the fund. Such investments may be made only in interest-bearing obligations of the United States or in obligations guaranteed as to both principal and interest by the United States. Such obligations may be acquired (I) on original issue at the issue price, or (II) by purchase of outstanding obligations at the market price. The purposes for which obligations of the United States may be issued under the Second Liberty Bond Act are hereby extended to authorize the issuance at par of special obligations exclusively to the Trust Fund. Such special obligations shall bear interest at a rate equal to the average rate of interest, computed as to the end of the calendar month next preceding the date of such issue, borne by all marketable interest-bearing obligations of the United States then forming a part of the public debt; except that if such average rate is not a multiple of one-eighth of 1 percent, the rate of interest of such special obligations shall be the multiple of one-eighth of 1 percent next lower than such average rate. Such special obligations shall be issued only if the Board determines that the purchase of other interest-bearing obligations guaranteed as to both principal and interest by the United States on original issue or at the market price, is not in the public interest.

(ii) SALE OF OBLIGATIONS.—Any obligations acquired by the Trust Fund (except special obligations issued exclusively to the Trust Fund) may be sold by the Board at the market price, and such special obligations may be redeemed at par plus accrued interest.

(iii) INTEREST ON CERTAIN PROCEEDS.—The interest on, and the proceeds from the sale or redemption of, any obligations held in the Trust Fund shall be credited to and form a part of the Trust Fund.

(3) TERM, PAY, AND TRAVEL EXPENSES OF MEMBERS.—

(A) TERM.—Each member of the Board shall be appointed for a term of 2 years; except that any member appointed to fill a vacancy occurring before the expiration of the term for which his predecessor was appointed shall be appointed only for the remainder of such term.

(B) PAY.—Members of the Board shall receive compensation at the rate of $100 for each day they are engaged in the performance of their duties as members of the Board.

(C) TRAVEL EXPENSES.—While away from their homes or regular places of business in performance of services for the Board, members of the Board shall be allowed travel expenses, including a per diem in lieu of subsistence, in the same manner as persons employed intermittently in the Government service are allowed expenses under section 5703 of title 5 of the United States Code.

(d) RESTRICTION ON THE USE OF THE TRUST FUND.—Except as provided in subsection (b)(4), amounts in the Trust Fund shall be available only for purposes of making payments under section 2.

SEC. 4. ELIMINATION OF DOUBLE TAX ON DIVIDENDS.

(a) DIVIDENDS RECEIVED BY INDIVIDUALS.—

(1) IN GENERAL.—Subsection (a) of section 116 of the Internal Revenue Code of 1954 (relating to partial exclusion of dividends received by individuals) is amended to read as follows:

"(a) EXCLUSION FROM GROSS INCOME.—Gross income does not include amounts received by an individual as dividends from domestic corporations. For purposes of the preceding sentence, amounts received by an individual as national dividend payments under the National Dividend Act of 1984 shall be treated as dividends from domestic corporations."

(2) TECHNICAL, CONFORMING, AND CLERICAL AMENDMENTS.—

(A) The section heading of such section 116 is amended by striking out "PARTIAL EXCLUSION" and inserting in lieu thereof "EXCLUSION".

(B) The table of sections for part III of subchapter B of chapter 1 of such Code is amended by striking out the item relating to section 116 and inserting in lieu thereof the following:

"Sec. 116. Exclusion of dividends received by individuals."

(C) Paragraph (4) of section 301(e) of such Code (relating to special rules) is amended by striking out "partial exclusion" and inserting in lieu thereof "exclusion".

(D) Paragraph (7) of section 643(a) of such Code (relating to certain definitions) is amended by striking out "partial exclusion" and inserting in lieu thereof "exclusion".

(b) DIVIDENDS RECEIVED BY CORPORATIONS.—

(1) IN GENERAL.—Subsection (a) of section 243 of such Code (relating to dividends received by corporations) is amended to read as follows:

"(a) GENERAL RULE.—In the case of a corporation, there shall be allowed as a deduction an amount equal to 100 percent of the amount received as dividends from a domestic corporation which is subject to taxation under this chapter."

(2) DIVIDENDS ON CERTAIN PREFERRED STOCK.—Section 244 of such Code (relating to dividends received on certain preferred stock) is amended to read as follows:

"SEC. 244. DIVIDENDS RECEIVED ON CERTAIN PREFERRED STOCK.

"In the case of a corporation, there shall be allowed as a deduction an amount computed as follows:

"(1) First determine the amount received as dividends on the preferred stock of a public utility which is subject to taxation under this chapter and with respect to which the deduction provided in section 247 for dividends paid is allowable.

"(2) Then multiply the amount determined under paragraph (1) by the fraction—

"(A) the numerator of which is 14 percent, and

"(B) the denominator of which is that percentage which equals the highest rate of tax specified in section 11(b).

"(3) Finally ascertain the amount which is 100 percent of the excess of—

"(A) the amount determined under paragraph (1), over

"(B) the amount determined under paragraph (2)."

(3) TECHNICAL, CONFORMING AND CLERICAL AMENDMENTS.—

(A) Section 243 of such Code (relating to dividends received by corporations) is amended by striking out subsection (b) and by redesignating subsections (c) and (d) as subsections (b) and (c), respectively.

(B) Subsection (b) of section 246 of such Code (relating to rules applying to deductions for dividends received) is amended by striking out "243(a)(1), 244(a)" each time it appears and inserting in lieu thereof "243, 244" and by striking out "85 percent of".

(C) Paragraph (4) of section 804(a) of such Code (relating to application of section 246(b) to taxable investment income) is amended by striking out "243(a)(1), 244(a)" and inserting in lieu thereof "243, 244".

(D) Subparagraph (B) of section 809(d)(8) of such Code (relating to application of section 246(b) to gain or loss from operations) is amended by striking out "243(a)(1), 244(a)" each place it appears and inserting in lieu thereof "243, 244".

(E) Subparagraph (C) of section 861(a)(2) of such Code (relating to income from sources within the United States) is amended by striking out "243(d)" and inserting in lieu thereof "243(c)".

(F) Subparagraph (B) of section 1504(c)(2) of such Code (relating to definition of includible insurance companies), is amended by striking out clause (i) and by redesignating clauses (ii) and (iii) as clauses (i) and (ii), respectively.

(c) The amendments made by this section shall apply to taxable years ending after the date of the enactment of this Act.

SEC. 5. LIMITATION ON CORPORATE INCOME TAXES AND ON NEW FEDERAL SPENDING.

(a) LIMITATION ON CORPORATE INCOME TAXES.—Notwithstanding any other provision of law, the maximum rate of tax imposed by section 11 of the Internal Revenue Code of 1954 shall not be increased above 46 percent.

(b) LIMITATION ON NEW FEDERAL SPENDING.—Title IV of the Congressional Budget Act of 1974 is amended by redesignating section 404 as section 405 and by inserting the following new section after section 403:

"LIMITATION ON NEW FEDERAL SPENDING

"SEC. 404. (a) It shall not be in order in either the House of Representatives or the Senate to consider any bill or resolution under section 301 or 310 of this Act in which the appropriate level of total budget outlays exceeds the level of total budget outlays set for the fiscal year ending September 30, 1983, in the resolution adopted under section 310 of this Act with respect to that year.

"(b) This section shall expire five years from the day the National Dividend Act of 1984 becomes effective."

SEC. 6. CALCULATION OF DEFICIT ADJUSTMENT AMOUNT.

(a) The amount to be deducted from the national dividend payment under section 2(b)(1)(B) of this Act as the deficit adjustment in any year shall be—

(1) the appropriate level of the Federal budget deficit set for the fiscal year ending in the calendar year in which the national dividend payment is to be made by the second concurrent resolution on the budget adopted with respect to that fiscal year pursuant to title III, section 310 of the Congressional Budget Act of 1974.

SEC. 7. DEFINITIONS.

For purposes of this Act—

(1) BOARD.—The term "Board" means the National Dividend Review Board established by section 3(c).

(2) FEDERAL ELECTION.—The term "Federal election" means any general election in which Members of (including any Delegate or Resident Commissioner to) Congress are elected or in which the President and Vice President are elected.

(3) SECRETARY.—The term "Secretary" means the Secretary of the Treasury or his delegate.

(4) STATE.—The term "State" includes the District of Columbia, the Commonwealth of Puerto Rico, and any territory or possession of the United States.

(5) TRUST FUND.—The term "Trust Fund" means the National Dividend Payment Trust Fund established by section 3(a).

STATEMENT OF RICHARD ROSENBAUM, COUNSEL, COMMITTEE FOR A RESPONSIBLE TAX POLICY, WASHINGTON, DC

Senator Chafee. Mr. Rosenbaum.

Mr. Rosenbaum. Mr. Chairman, Senator Symms, I'm Dick Rosenbaum, counsel to the Committee for a Responsible Tax Policy. And this is my colleague on my left, Benjamin Fein. We appreciate very much this opportunity to appear before you to present a new reform program, which if adopted would greatly limit tax abuse and simplify the tax system. It would do so without abandoning the principle of a progressive income tax or sacrificing the use of the income tax as an instrument for public policy.

Certain proposed legislation would substitute for measured reform a radical restructuring of the present tax system. Less sweeping changes could accomplish similar goals and avoid the economic disruptions that a flat tax would bring with it.

A flat tax system, necessarily undercuts the fundamental principle of progressivity. A new system under which the millionaire would pay the exact same percentage of his income as a middle-class wage earner is not likely to retain support. As millions of economic decisions have already been made on the reasonable assumption that tax changes will proceed incrementally, a flat tax system would lead to economic chaos. There are, therefore, staggeringly high economic and social costs connected with a flat tax, the full extent of which we believe are unknowable.

A flat tax would deprive Congress of the tax system as an economic tool to stimulate various forms of economic activity. The construction and rehabilitation of low-income housing, the promotion of energy production and conservation, including new sources of energy, are but two examples of the use of the tax system as a supple tool for directing investment to promote public policy.

As a result of a flat tax, economic disruptions would ensue in many businesses where decisions have been made in good faith reliance on the current Tax Code.

A flat tax system, whatever its simplistic appeal as a nostrum, raises very serious problems. Therefore, we offer the following alternative.

Simplification of the current system. Our proposal, though novel, employs modest changes in the tax system while realizing the results desired by so many taxpayers.

To simplify the filing of tax returns, we suggest the elimination of most or all of the nonrefundable personal credits as well as certain itemized deductions. These items are set forth in our submitted paper.

We would substitute a higher allowance for personal exemptions and a substantially increased zero bracket amount. In conjunction with those changes, a new tax rate structure beginning at about 20 percent would be adopted. That bracket would be enlarged to apply to taxpayers who earn up to $35,000 a year. Effectively, this would be a flat tax for over 50 percent of American families.

When most taxpayers bewail the system's complexity, they are really talking about the host of tax forms and schedules. We estimate that three out of every four Americans would thus be able to file their return on a modified short form. This is simplicity.

The backup tax is the second part of our proposal, and it's intended to ensure that everyone pays a minimum amount of tax regardless of deductions, credits, or losses. We do not agree with those who want to eliminate all such items from the Tax Code. What we do believe is that the rich should not be permitted to exploit favorable tax treatment of particular provisions so as to eliminate any tax liability. To achieve the goal of eliminating such abuse, an enhanced minimum tax, the backup tax, is the appropriate vehicle.

The present alternative minimum tax is a nightmare. Some taxpayers are still able to reduce or eliminate earned income and investment income and thereby to negate the very purpose of the minimum tax. Notwithstanding its existence, many perceive that the wealthy are still able to avoid such taxes.

We propose that the present alternative minimum tax be scrapped and that in its place be substituted an all-encompassing backup tax. The backup tax would require that taxpayers pay tax at regular income tax rates on at least 30 percent of their real gross income. In order to ensure that this does not apply to middle- and lower-income taxpayers, and increase complexity, a specific deduction of $20,000 would be allowed after determining 30 percent of real gross income.

Regular income tax rates ranging from about 20 percent to 50 percent would apply to the greater of 30 percent of the taxpayers' real gross income or his taxable income. A backup tax calculated in this manner would ensure that taxpayers will pay taxes on their principal source of income without regard to unrelated loss producing activities. It treats all deductions and losses alike, but it does not permit a taxpayer to use too many such deductions to reduce his tax liability to nothing.

The specifics of calculating real gross income under our proposal are set forth at greater length in the paper we have submitted to the committee.

Under the backup tax there is no change in the types of incentives granted under the tax law, incentives which are an essential component of economic planning. The proposal ends the current confusion of the existing alternative minimum tax system, by which certain losses or deductions are tainted deductions, while others are not. It carries out the intent of an alternative or backup tax. It ensures that every taxpayer with real gross income of $67,000 or more would pay some tax at a progressive rate. However, it does not do away with either the principle or fact of deductions and credits as such.

In conclusion, in our eagerness to achieve the goals of equity and simplicity, we should not ignore the fact that the present tax system is an expression of the complicated and advanced economic system of which it is a part. We believe that our proposals will do much to achieve these goals without necessitating the wholesale abandonment of our progressive tax system. We believe that it will do much to simplify the filing of tax returns by most citizens, and to ensure that wealthy taxpayers do not abuse the favorable tax treatment accorded certain activities. And we look forward to cooperating with Congress, the Treasury, and the joint committee in further study and development of our proposal.

Thank you very much.

Senator Chafee. Thank you very much.

[The prepared written statement of Mr. Rosenbaum follows:]

STATEMENT OF RICHARD M. ROSENBAUM
COUNSEL TO THE COMMITTEE FOR A RESPONSIBLE TAX POLICY
DELIVERED TO THE SENATE FINANCE COMMITTEE
ON THURSDAY, SEPTEMBER 20, 1984

I. INTRODUCTION

I AM DICK ROSENBAUM, COUNSEL TO THE COMMITTEE FOR A RESPONSIBLE TAX POLICY, AND THIS IS MY COLLEAGUE, BEN FEIN. WE APPRECIATE THIS OPPORTUNITY TO APPEAR BEFORE YOU TO PRESENT A NEW REFORM PROGRAM WHICH IF ADOPTED WOULD GREATLY LIMIT TAX ABUSE AND SIMPLIFY THE TAX SYSTEM. IT WOULD DO SO WITHOUT ABANDONING THE PRINCIPLE OF A PROGRESSIVE INCOME TAX OR SACRIFICING THE USE OF THE INCOME TAX AS AN INSTRUMENT OF PUBLIC POLICY.

CERTAIN PROPOSED LEGISLATION WOULD SUBSTITUTE FOR MEASURED REFORM A RADICAL RESTRUCTURING OF THE PRESENT TAX SYSTEM. LESS SWEEPING CHANGES COULD ACCOMPLISH SIMILAR GOALS AND AVOID THE ECONOMIC DISRUPTIONS THAT A FLAT TAX WOULD BRING WITH IT.

II. SHORTCOMINGS OF THE FLAT TAX

A FLAT TAX SYSTEM NECESSARILY UNDERCUTS THE FUNDAMENTAL PRINCIPLE OF PROGRESSIVITY. A NEW SYSTEM UNDER WHICH THE MILLIONAIRE WOULD PAY THE EXACT SAME PERCENTAGE OF HIS INCOME AS A MIDDLE-CLASS WAGE EARNER IS NOT LIKELY TO RETAIN SUPPORT. AS MILLIONS OF ECONOMIC DECISIONS HAVE ALREADY BEEN MADE ON THE REASONABLE ASSUMPTION THAT TAX CHANGES WILL PROCEED INCREMENTALLY, A FLAT TAX SYSTEM WOULD LEAD TO ECONOMIC CHAOS. THERE ARE, THEREFORE, STAGGERINGLY HIGH ECONOMIC AND SOCIAL COSTS CONNECTED WITH A FLAT TAX, THE FULL EXTENT OF WHICH, WE BELIEVE, ARE UNKNOWABLE.

A FLAT TAX WOULD DEPRIVE CONGRESS OF THE TAX SYSTEM AS AN ECONOMIC TOOL TO STIMULATE VARIOUS FORMS OF ECONOMIC ACTIVITY. THE CONSTRUCTION AND REHABILITATION OF LOW-INCOME HOUSING, THE PROMOTION OF ENERGY PRODUCTION AND CONSERVATION INCLUDING NEW SOURCES OF ENERGY, ARE BUT TWO EXAMPLES OF THE USE OF THE TAX SYSTEM AS A SUPPLE TOOL FOR DIRECTING INVESTMENT TO PROMOTE PUBLIC POLICIES.

AS A RESULT OF A FLAT TAX, ECONOMIC DISRUPTIONS WOULD ENSUE IN MANY BUSINESSES WHERE DECISIONS HAVE BEEN MADE IN GOOD FAITH RELIANCE ON THE CURRENT TAX CODE. A FLAT TAX SYSTEM, WHATEVER ITS SIMPLISTIC APPEAL AS A NOSTRUM, RAISES VERY SERIOUS PROBLEMS. WE OFFER THE FOLLOWING ALTERNATIVE.

III. A NEW PROPOSAL

A. SIMPLIFICATION OF THE CURRENT SYSTEM

OUR PROPOSAL, THOUGH NOVEL, EMPLOYS MODEST CHANGES IN THE TAX SYSTEM WHILE REALIZING THE RESULTS DESIRED BY SO MANY TAXPAYERS.

TO SIMPLIFY THE FILING OF TAX RETURNS WE SUGGEST THE ELIMINATION OF CERTAIN NONREFUNDABLE PERSONAL CREDITS AS WELL AS CERTAIN ITEMIZED DEDUCTIONS. THESE ITEMS ARE SET FORTH IN OUR SUBMITTED PAPER. WE WOULD SUBSTITUTE A HIGHER ALLOWANCE FOR PERSONAL EXEMPTIONS AND A SUBSTANTIALLY INCREASED ZERO BRACKET AMOUNT. IN CONJUNCTION WITH THOSE CHANGES A NEW TAX RATE STRUCTURE BEGINNING AT 20-25% WOULD BE ADOPTED. THAT BRACKET WOULD BE ENLARGED TO APPLY TO TAXPAYERS WHO EARN APPROXIMATELY UP TO $35-40,000 A YEAR. EFFECTIVELY, THIS WOULD BE A FLAT TAX FOR OVER 50% OF AMERICAN FAMILIES.

WHEN MOST TAXPAYERS BEWAIL THE SYSTEM'S COMPLEXITY, THEY ARE REALLY TALKING ABOUT THE HOST OF FORMS AND SCHEDULES. WE

ESTIMATE THAT THREE OUT OF EVERY FOUR FAMILIES WOULD THUS BE ABLE TO FILE THEIR RETURN ON A MODIFIED SHORT FORM.

B. THE BACK-UP TAX

THE SECOND PART OF OUR PROPOSAL IS INTENDED TO INSURE THAT EVERYONE PAYS A MINIMUM AMOUNT OF TAX REGARDLESS OF HIS DEDUCTIONS, CREDITS, OR LOSSES. WE DO NOT AGREE WITH THOSE WHO WANT TO ELIMINATE ALL SUCH ITEMS FROM THE TAX CODE. WHAT WE DO BELIEVE IS THAT THE RICH SHOULD NOT BE PERMITTED TO EXPLOIT FAVORABLE TAX TREATMENT OF PARTICULAR PROVISIONS SO AS TO ELIMINATE THEIR TAX LIABILITY. TO ACHIEVE THE GOAL OF ELIMINATING SUCH ABUSE, AN ENHANCED MINIMUM TAX--THE BACK-UP TAX--IS THE APPROPRIATE VEHICLE.

THE PRESENT ALTERNATIVE MINIMUM TAX IS A NIGHTMARE. SOME TAXPAYERS ARE STILL ABLE TO REDUCE OR ELIMINATE EARNED INCOME AND INVESTMENT INCOME AND THEREBY TO NEGATE THE VERY PURPOSE OF THE MINIMUM TAX. NOTWITHSTANDING ITS EXISTENCE, MANY PERCEIVE THAT THE WEALTHY ARE STILL ABLE TO AVOID SUCH TAXES.

WE PROPOSE THAT THE PRESENT ALTERNATIVE MINIMUM TAX BE SCRAPPED AND THAT IN ITS PLACE BE SUBSTITUTED AN ALL-ENCOMPASSING BACK-UP TAX. THE BACK-UP TAX WOULD REQUIRE THAT TAXPAYERS PAY TAX AT REGULAR INCOME TAX RATES ON AT LEAST 30% OF THEIR "REAL GROSS INCOME". IN ORDER TO INSURE THAT THIS DOES NOT APPLY TO MIDDLE AND LOWER INCOME TAXPAYERS AND INCREASE COMPLEXITY, A SPECIFIC DEDUCTION OF $20,000 WOULD BE ALLOWED AFTER DETERMINING REAL GROSS INCOME.

REGULAR INCOME TAX RATES (RANGING FROM 25 TO 50 PERCENT) WOULD APPLY TO THE GREATER OF A TAXPAYER'S REAL GROSS INCOME

OR HIS TAXABLE INCOME. A TAX CALCULATED IN THIS MANNER WOULD INSURE THAT TAXPAYERS WILL PAY TAXES ON THEIR PRINCIPLE SOURCE OF INCOME WITHOUT REGARD TO UNRELATED LOSS PRODUCING ACTIVITIES. IT TREATS ALL DEDUCTIONS AND LOSSES ALIKE, BUT IT DOES NOT PERMIT A TAXPAYER TO USE TOO MANY SUCH DEDUCTIONS TO REDUCE HIS TAX LIABILITY TO NOTHING.

THE SPECIFICS OF CALCULATING "REAL GROSS INCOME" UNDER OUR PROPOSAL ARE SET FORTH AT GREATER LENGTH IN THE PAPER WE HAVE SUBMITTED TO T HE COMMITTEE.

UNDER THE BACK-UP TAX THERE IS NO CHANGE IN THE TYPES OF INCENTIVES GRANTED UNDER THE TAX LAW, INCENTIVES WHICH ARE AN ESSENTIAL COMPONENT OF ECONOMIC PLANNING. THE PROPOSAL ENDS THE CURRENT CONFUSION OF THE EXISTING ALTERNATIVE MINIMUM TAX SYSTEM, BY WHICH CERTAIN LOSSES OR DEDUCTIONS ARE "TAINTED DEDUCTIONS" WHILE OTHERS ARE NOT. IT CARRIES OUT THE INTENT OF AN ALTERNATIVE OR BACK-UP TAX. IT INSURES THAT EVERY TAXPAYER WITH REAL GROSS INCOME OF $57,000 OR MORE WOULD PAY SOME TAX AT A PROGRESSIVE RATE. HOWEVER, IT DOES NOT DO AWAY WITH EITHER THE PRINCIPLE OR FACT OF DEDUCTIONS AND CREDITS AS SUCH.

IV. CONCLUSION

IN OUR EAGERNESS TO ACHIEVE THE GOALS OF EQUITY AND SIMPLICITY, WE SHOULD NOT IGNORE THE FACT THAT THE PRESENT TAX SYSTEM IS AN EXPRESSION OF THE COMPLICATED AND ADVANCED ECONOMIC SYSTEM OF WHICH IT IS A PART. WE BELIEVE THAT OUR PROPOSALS WILL DO MUCH TO ACHIEVE THESE GOALS WITHOUT NECESSITATING THE WHOLESALE ABANDONMENT OF OUR PROGRESSIVE TAX SYSTEM. WE BELIEVE THAT IT WILL DO MUCH TO SIMPLIFY THE FILING OF TAX RETURNS BY MOST CITIZENS, AND TO ENSURE THAT WEALTHY TAXPAYERS DO NOT ABUSE THE FAVORABLE TAX TREATMENT ACCORDED CERTAIN ACTIVITIES. WE LOOK FORWARD TO COOPERATING WITH CONGRESS, THE TREASURY, AND THE JOINT COMMITTEE IN FURTHER STUDY AND DEVELOPMENT OF OUR PROPOSAL.

COMMITTEE FOR A RESPONSIBLE TAX POLICY

COMMENTS ON A FLAT-RATE INCOME TAX SYSTEM
AND
PRESENTATION OF AN ALTERNATIVE PROPOSAL

SUBMITTED TO THE
SENATE FINANCE COMMITTEE
FOR THE
WRITTEN RECORD OF HEARINGS HELD ON
MAJOR TAX REFORM OPTIONS
SEPTEMBER 20, 1984

Richard Rosenbaum, Esq.
Benjamin Fein, Esq.

I. INTRODUCTION

The Committee for a Responsible Tax Policy (CFRTP) is a national business, academic, legal, civic, minority and labor coalition committed to educating government and the public about the disastrous effects a drastic change in the progressive tax system would have on virtually all taxpayers and on the economy as a whole. CFRTP believes that full debate and public scrutiny should precede any change in Federal tax law. The American public must realize, before it is too late, that a tax system can either encourage investment, vitalize industry and benefit all segments of our society, or remove incentives, slow industrial expansion and curtail economic growth.

A troubled economy presents problems for everyone. A misguided tax system could present problems for generations.

CFRTP, therefore, wishes to express its appreciation to the Senate Committee on Finance for the opportunity to comment on the so-called flat or fair tax plans that are currently receiving attention in Congress and to present to this Committee an alternative tax proposal which will preserve our progressive tax system yet at the same time simplify the tax system for the overwhelming majority of taxpayers.

II. Need for Tax Reform

A. Overview

There is widespread belief today that the present federal income tax system is too complicated, riddled as it is with a multitude of credits, exclusions and deductions; that the present tax rates are too high; and that the system is unfair because upper income groups pay little or no income tax. Correspondingly, there is a clamor among these taxpayers for tax reform based upon the belief that an inevitable consequence of tax reform is tax relief.

In response to these taxpayers, a number of federal legislators have introduced bills before Congressional tax committees, the common effect of which would be a radical restructuring of the present tax system by shifting from a progressive to a flat tax system. It is our position that a shift to any of the proposed flat tax systems would not only fail to adequately address the concerns raised by the vast majority of taxpayers, but, moreover, would harm the economy and nation as whole. It is our position that many of the goals sought after by the vast majority of taxpayers may be achieved with certain changes to the present tax system and little, if any, economic disruption.

Before setting forth our proposal, we believe it necessary to set forth considerations in evaluating a tax reform proposal and the major proposals currently under discussion.

B. Essential Considerations

Whether creating or evaluating a comprehensive tax reform proposal, an individual must take into account several important considerations. First, revenue which is raised by the tax system should be collected in a manner which is as fair as possible, which produces as little unintended distortion in the economy as possible and which is as simple to administer and understand as possible. Second, the tax system of a complex economic society is used as an important policy tool in stimulating and directing the economy. In short, whether creator or evaluator of a tax proposal, the individual must judge the proposal by considering equity, efficiency, simplicity, and overall economic policy.

C. Major Flat Tax Proposals

During the 98th Congress more than a dozen flat-tax proposals were introduced into both houses of Congress. Although these bills vary, the common theme of all flat-tax proposals is a substantial broadening of the tax base coupled with a significant reduction of marginal tax rates. The theory underlying this theme is that once you have eliminated the many exclusions, deductions and credits found in the Internal Revenue Code the amount of income that is subject to tax increases, permitting present levels of revenue to be raised with lower tax rates.

For the sake of brevity we will not discuss all of the flat-tax bills which are now pending. Instead, we will set forth a summary of the two better known flat-tax proposals: The Fair Tax Act of 1983 (FAIR) introduced by Senator Bradley (D-NJ) as S1421 and the Fair and Simple Tax Act of 1984 (FAST) introduced by Senator Kasten (R-Wis) as S2948.

1. The FAIR Proposal

As a flat tax system, FAIR broadens the income tax base by eliminating or limiting many tax credits, deductions and exclusions available to taxpayers, while at the same time reducing effective tax rates to a range from 14 to 30 percent for individuals through the use of a two tier structure for determining tax liability.

The two tier structure provides that taxable income (adjusted gross income minus deductions and exemptions) is subject to a regular tax at a 14 percent rate. In addition, the structure provides that adjusted gross income above certain levels is subject to a surtax from 12-16%. The combined effect of these two taxes is to create three income tax brackets: 14 percent, 26 percent and 30 percent.

Significant deductions and exclusions eliminated are:

State and local tax deductions (other than income and real property).

The two-earner deduction.

The dividend exclusion.

Medical insurance and group term life insurance premiums paid by employers but which are nontaxable to employees.

The exclusion of interest on mortgage subsidy and industrial revenue bonds.

The capital gain deduction.

Significant tax provisions retained are:

Home mortgage interest deduction.

State and local income and real property tax deduction.

Charitable contribution deduction.

Individual retirement account (IRA) and Keogh plan deductions.

Exclusion for general obligation municipal bond interest.

Earned income credit.

Social security benefit exemption for low and moderate income individuals.

Other significant special tax provisions are retained. However, they are modified by FAIR. These include the following:

Homeowner exclusion of up to $125,000 of the gain on the sale of a residence by a taxpayer age 55 and older (retained for computing FAIR's base tax but not the surtax).

Personal interest deductions. (FAIR allows nonbusiness interest deductions, other than home mortgage interest, only to the extent that the amount does not exceed the net investment income of the taxpayer for the taxable year, incorporating concepts similar to those in the existing alternative minimum tax.)

The medical expense deduction is retained, however, only expenses above ten percent of adjusted gross income would be deductible.

In short, the bill retains those provisions (although modified in some cases) that are of most concern to a majority of taxpayers. But, it is important to note that the tax benefits of these popular deductions have been "turned on their heads." Under FAIR's two tier tax structure, the home mortgage interest and other deductions offset income only at the taxpayer's base rate of 14 percent. Income subject to the 12-16% surtax, however, may not be offset by these deductions. For middle income taxpayers, those who would be subject to tax liabilities of from 26-30%, the effect of this structure is to reduce by about one-half the value of those deductions. Similarly, although FAIR raises the zero bracket amount (renamed the standard deduction) and the personal exemption, the tax benefit of each, because they offset income only at the base rate of 14%, is reduced by about one-half.

Another provision requires inclusion in income of gain derived from increases in cash surrender value and dividends from annuity, life insurance and endowment contracts. In addition, the accelerated cost recovery system would be drastically revised, with the recovery periods greatly stretched out (for example the period for buildings would increase from 18 to 40 years), but the double declining balance rate applicable would increase from 175% to 250%. The alternative minimum tax would be repealed.

FAST

The FAST proposal like the FAIR proposal advocates a flat-tax structure. Accordingly, it too would broaden the income base and reduce the income tax rate to be applied. Unlike the FAIR proposal it would index for inflation the personal exemption and zero bracket amount (both increased under the proposal), as well as a new employment income exclusion, and the basis of certain property for computing capital gain or loss.

FAST eliminates many special tax provisions for individuals. Significant ones are:

State and local tax deductions (except real property).

Two-earner deduction.

Dividend exclusion.

Capital gain deduction. However, capital losses are deductible in full and without limit after a ten-year phase-in.

Personal interest other than on home mortgage and educational loans.

Casualty and theft loss deduction.

Similar to FAIR, FAST retains the more popular deductions. These are:

Home mortgage interest deduction

Real property tax deduction

Charitable contribution deduction.

IRA and Keogh deductions.

General obligation municipal bond interest exclusion.

Earned income credit (slightly modified).

Homeowner exclusion of up to $125,000 of the gain on the sale of a residence by taxpayers age 55 and older.

Social security benefit exemption for low and moderate income individuals.

The medical expense deduction is retained, however, only expenses above ten percent of adjusted gross income would be deductible.

FAST contains provisions identical to FAIR repealing the exclusions for mortgage subsidy and industrial revenue bond interest, and including unrealized income from annuity, life insurance and endowment contracts.

FAST retains the alternative minimum tax.

Although the bottom tax rate under FAST is considerably higher than the bottom rate under FAIR, FAST permits taxpayers to exclude a percentage of their employment income in arriving at taxable income. The percentage is reduced as adjusted gross income rises. Under FAST the effective rate of tax ranges from 20 percent for employment income below $39,300 to 25 percent for employment income in excess of $102,000. It should be noted that all investment income is also taxed at 25 percent.

D. Shortcoming of the Major Flat Tax Proposals

An analysis of the major flat tax proposals highlights a number of problems. One is that these flat tax proposals undercut the fundamental principle of United States tax policy for the past seven decades -- namely, progressivity; that is, the amount of an individual's tax liability is based upon the ability to pay.

It may be argued that progressivity should not be the basis upon which the income tax system is based. Without reaching the merits of this position, it is essential to understand that right or wrong, good or bad, a great many economic decisions have been arrived at based upon this policy. Moreover, many of the normative values upon which this society developed rely in part on the concept of a progressive income tax system. The adoption of either flat-tax system, therefore, despite claims that it is neutral with respect to investment decisions and current revenue raising, poses both dollar and social costs the amount or extent of which are unknown and perhaps unknowable. Indeed, the Joint Committee on Taxation has acknowledged this fact by stating that, in arriving at estimates of revenue under both proposals, it assumes that all economic decisions would remain static. David H. Brockway, Chief of Staff of the Joint Committee, in discussing the accuracy of such assumption in a letter to Congressman Jack F. Kemp dated August 9, 1984 concluded that ". . . this assumption is not realistic. . . ." No alternative assumptions have been set forth because of the unknown and unknowable effect of such changes on economic behavior.

A second criticism of these flat tax proposals is the assumption that economic efficiency would be enhanced if all investment decisions were "tax neutral." The assumption here is that Congress should not be able to use the tax system as an economic tool to affect the delivery of goods and services or to stimulate various forms of investment activity. In an economic society as vast and complex as ours that very ability enables the government to rapidly change the economic course of this nation.

A prime example of the use of the tax system in this manner is the nationwide construction of low-income housing and housing for the elderly. Stimulated by tax incentives, upper income bracket individuals invested in the construction of low income housing and thereby provided housing for millions of people without the creation of a vast federal bureaucracy. Without the ability of Congress to provide, through adjustments in the tax structure, incentives, which low income housing by its very nature could not provide, such housing would not have been built swiftly and efficiently.

Another example of the use of the tax system as a tool of economic planning (as well as national security planning) can be observed in the area of energy, where tax incentives encouraged the search for new sources of energy -- for example, solar and geothermal on the one hand and conservation on the other, the results of which reduced our dependence on unfriendly or potentially hostile foreign sources. There are other examples. But the point is not how the tax system has been used in the past as a policy tool, but whether it will continue to be available as such in the future. As the economy grows even larger and more complex, the answer, it seems, should be an unqualified yes.

A third criticism deals with the economic disruption to various industries such as insurance, oil and gas, real estate and equipment manufacturing which would be caused by the adoption of a flat rate tax system. For example, the decision to purchase or invest in various insurance products, premised on long-term investment and capital formation, is based on their specific tax benefits. Absent such benefits, such products would not offer a competitive rate of return when compared with bank and brokerage financial products. The adoption of a flat tax, therefore, would wreak havoc on an important component of the financial sector of the economy.

With regard to other specified industries, countless long-term economic commitments were made based upon the assumption of reasonable certainty in the tax law. Indeed, in virtually every sector of the economy business and investment decisions have been made after considering the tax consequences. To make drastic changes in the existing tax system raises a real possibility of creating not tax reform but economic chaos.

A fourth criticism deals with some of the assumptions underlying the major tax proposals. First, that a tax system must be simple for all taxpayers and second, that a simpler system is a fairer system.

To be sure, no one desires a tax system that is unnecessarily complex (or, for that matter, one that is unfair). But it is essential to recognize that a tax system is merely a reflection of the society in which it exists. The more economically complex a society is, the more complicated its tax system will become. This is not to suggest, however, that simplification is an unattainable goal for most taxpayers. Rather, it is to suggest that those who have complicated economic lives have and will continue to have complicated tax problems, without regard to any tax system which may be adopted. However, as is often the case, these individuals are able to bear the costs incurred in obtaining the necessary professional assistance and, accordingly, society's resources should not be squandered in an attempt to reduce those costs. Indeed, 70% of all taxpayers do not currently itemize their deductions. Simplicity for the remaining 30% should not be achieved at the cost of higher taxes for the other 70%.

That a flat tax system will also be fairer requires us to ask what is meant by fair. If, as we believe, fair means that an individual pays tax based upon his ability to pay, then, as noted earlier, a flat tax is, by definition, unfair.

Mindful of the average taxpayer's desire for fairness and simplicity, we ask you to consider the following alternative.

III. An Alternative - Back-Up Tax System

A. Introduction

The proposal set forth below is an attempt to redress the inadequacies (both real and perceived) of the current tax system while at the same time avoid the many shortcomings of proposals discussed previously. The proposal is revenue neutral and, therefore, does not address the budget deficit problem. The proposal does not replace the current tax system nor call for its radical restructuring. Instead, the proposal, although novel and unique, suggests more modest changes to the tax system while insuring the realization of the results desired by the vast majority of taxpayers.

To reiterate, for most taxpayers there are principally two problems with the present tax system. One is the belief that those with the ability to pay taxes are not paying their fair share. The other is that the present system is simply too complicated.

B. Simplification

To simplify the present tax system the following is suggested: eliminate most of the array of nonrefundable personal credits allowable under Subpart A of Part IV of the Internal Revenue Code of 1954, certain exclusions and certain of the itemized deductions (for example, sales and personal property tax, two-earner deduction, dividend exclusion and noninclusion of medical insurance) and replace both with a higher allowance for personal exemptions and a substantially increased zero bracket amount.

For the vast majority of taxpayers the effect of such changes would be significant. The cry of the average taxpayer that the system is too complicated does not necessarily reflect his frustration in dealing with the Internal Revenue Code. Most have never seen or read that voluminous document. Rather, it is his frustration in completing a host of forms and schedules, in particular the Form 1040 and Schedule A, issued by the Internal Revenue Service.

The increase in the allowance for personal exemptions and the higher zero bracket amount, in turn, would have two direct consequences. First, by replacing the credits and deductions claimed by taxpayers, the higher allowance for personal exemptions and greater zero bracket amount would insure that such taxpayers as a group are not subject to greater tax liability. Second, for those taxpayers who now are unable to avail themselves of those credits and deductions (generally those in the lower income brackets) the higher allowance for personal exemptions and greater zero bracket amount would reduce, if not eliminate, their federal income tax liability. With the ever-increasing rise in social security taxes, sales taxes and other state and local taxes, which disproportionately negatively affect these lower income bracket taxpayers, such a reduction in their federal income tax liability would be most equitable. By eliminating certain of the credits and deductions and increasing the deduction for personal exemptions and the amount of the "alternative" zero bracket amount, over 70% of the taxpayers would utilize the zero bracket amount in lieu of itemizing deductions. Those taxpayers, therefore, would be able to quickly settle their accounts with the government, doing so on a simplified one page two-sided tax form.

It is also suggested that the number of income tax brackets be reduced in number to five or six. However, because the higher personal exemption and increased zero bracket amount would result in fewer individuals in the lower income groups paying any tax, as in the case of FAST, the bracket for the initial marginal rate would be the largest and begin in the 20-22% range. Probably, rates would not exceed 25% for taxpayers with gross income of $35,000 to $40,000. As a result, most taxpayers would receive the benefits of a modified flat tax. However, for individuals with higher incomes, there would continue to be progressive rates, increasing in 5% or 6% steps up to a maximum of 45 to 50 percent.

C. Back-Up Tax

Insuring that everyone pays his or her fair share of taxes is the central focus of our proposal. We begin, however, by correcting two widely held misperceptions: first, that the tax system is filled with "loopholes" and second, that these "loopholes" enable the rich to evade paying taxes.

Ask a taxpayer to define "loophole" and he will say words such as tricks, gimmicks and devices. More specifically, he will refer to a deduction which someone else utilizes but which he does not. That is why when a taxpayer is asked to name one so-called loophole, the biggest one of all, the deduction for home mortgage interest, is rarely, if ever, mentioned. A loophole, however, is not a gimmick or trick, it is not improper or immoral. It is, as noted previously, a reflection of the efforts of Congress to achieve specific policy objectives.

Equally important to understand is that the rich do pay taxes. In fact, Department of Treasury statistics indicate that the top 10% of all taxpayers pay 50% of all income tax collected, that the next 40% pay 40% of income tax collected and that the lowest 50% pay only 10% of income tax collected.

Notwithstanding these figures, there are, perhaps, some taxpayers who, by combining an inordinate number of credits, exclusions and deductions, reduce their tax liabilities below what is generally perceived as fair -- below a minimum threshold. To insure that no one's tax liability falls below that minimum threshold, we address ourselves to the concept of the minimum tax.

The concept of a minimum tax dates back almost 20 years, when Senator Russell Long called for the enactment of what he described as an "optional simplified tax," which would have given taxpayers an election either to compute taxable income in the normal manner and apply the regular rates or to apply a lower rate schedule to an expanded tax base. Since that time, successive Presidents and Congresses have labored over and enacted into law various forms of a tax concept that would insure that those individuals who would be in the higher income tax brackets absent the use of various tax preferences would pay some federal income tax.

Today, that concept is found in Section 55, titled, The Alternative Minimum Tax for Taxpayers other than Corporations. Enacted in its present form in 1982, this minimum tax imposes an alternative tax calculated at the rate of 20 percent on an expanded concept of taxable income, if the minimum tax is greater than the "regular tax." In general, the "regular tax" means all taxes imposed by the income tax law, Chapter 1 of the Internal Revenue Code, reduced by the sum of the credits allowable under Subparts A, B and D of Part IV.

Calculation of the alternative minimum tax begins with adjusted gross income (AGI) before net operating loss deductions. AGI is then increased by twelve specific items of tax preference and by any interest, deducted in calculating AGI, on indebtedness to acquire or carry a "limited business interest." Such an interest is defined in Section 55(e)(8) as a limited partnership interest or shares of an S corporation if the shareholder does not participate actively in the management of the corporation. Once such items are added back to AGI, an alternative tax net operating loss deduction is then computed using such modified AGI and the alternative tax itemized deductions. From the AGI as so adjusted there may be deducted a limited set of alternative tax itemized deductions, essentially charitable, medical and casualty loss deductions, as well as an interest deduction. However, this interest deduction is limited to interest incurred in connection with residential property, and other interest to the extent it does not exceed net investment income of the taxpayer, computed with the deduction only of directly connected "above-the-line" deductions which are not items of tax preference, and including income from any "limited business interest". Finally an exemption of $30,000 for a single individual and $40,000 on a joint return is allowed. The balance, if any, is subject to a tax at the rate of 20 percent.

As may be apparent from the foregoing "simplified" explanation, the present minimum tax is difficult to comprehend or determine. Second, because the add-back is limited to a specific list of items of tax preferences, albeit a long list, some taxpayers by making use of certain other losses or deductions are able to reduce or eliminate earned income and investment income and thereby to negate the very purpose of the minimum tax. Most importantly, it is perceived by many that the wealthy are able to evade such tax.

We propose that the present Section 55 alternative minimum tax be scrapped and that in its place be substituted a new, all-encompassing and simplified back-up tax. The back-up tax would require that all taxpayers pay tax (at regular income tax rates) on at least 30% of their "Real Gross Income." In order to insure that this does not apply to most middle and lower income taxpayers and increase complexity, a specific deduction of $20,000 would be allowed after arriving at 30% of Real Gross Income. Regular income tax rates would apply to the greater of 30% of a taxpayer's Real Gross Income less the specific deduction, or his taxable income. A tax calculated in this manner would insure that taxpayers will pay taxes on their principal source of income without regard to unrelated loss producing activities in which they may engage. It treats all deductions and losses alike -- but it does not permit a taxpayer to use too many deductions or credits in toto to reduce his tax liability to nothing. It does not distinguish between "good deductions" and "not so good" deductions (that is, certain enumerated tax preferences) in computing the alternative tax. It also enables us to simplify certain limitations presently cluttering the Code itself. For example, the thirty or fifty percent limitations on charitable deductions or the complex limitations on investment interest deductions would be unnecessary. They would all be caught in the all-inclusive umbrella of the back-up tax and there would be no need for complex rules regarding carry-backs and carry-forwards. Moreover, by its very mechanics, the back-up tax would not apply to anyone with Real Gross Income of approximately $70,000 or less.

The critical aspect of this proposal is to define Real Gross Income. Real Gross Income would be gross income from all sources reduced only by items which would be deductible as expenses directly incurred in generating such income. Real Gross Income would include net business income, personal service income (including the incentive stock option tax preference) and investment income, for example, interest, dividends, royalties, passive rent (of net lessors, limited partners and inactive S corporation shareholders), depreciation recapture on investment property, and capital gains (net of capital losses but without the net capital gain deduction) attributable to the disposition of property held for investment. In the case of pass-through entities, business income, personal service income and investment income would flow through to the individual.

Only positive income amounts would be included in such calculation so that losses from investment activities, for example, would not reduce the calculation of Real Gross Income. Such losses and other deductions would still be deductible under the regular income tax system and hence would effectively continue to result in tax savings unless and until such losses and deductions exceeded the sum of $20,000 and 70% of the taxpayer's Real Gross Income.

As indicated above, the only expenses which would be considered in determining Real Gross Income are those allocable to business and personal service income which are deductible in arriving at adjusted gross income, and investment expenses attributable to investment activities (such as state and local property taxes, bad debts, depreciation and other expenses) and directly related to the production of investment income. If there were a loss in the category of either business income, personal service income or investment income, the loss in one category would not offset the other categories for purposes of calculating the back-up tax.

The back-up tax is intended to insure that those taxpayers with the ability to pay income taxes pay their fair share by limiting the amount of taxable income which they would otherwise be allowed to shelter. Moreover, the back-up tax makes no change in the types of incentives granted under the tax law, which incentives are an essential component of economic planning and capital formation. It ends the current confusion under the existing alternative minimum tax system that certain losses or deductions are "tainted deductions" (that is, tax preferences) while others are not. It permits the removal of existing specific limitations on specific deductions, for example, charitable contributions and investment interest and, thereby, further simplifies a taxpayer's calculation of his tax liability. It carries out the intent of an alternative or back-up tax -- it insures that every rich taxpayer will pay some minimum tax and that such tax is computed on a progressive basis.

IV. Conclusion

Tax reform is a complicated process the goals of which are greater equity and simplicity in the tax system. The present tax system, however, does not exist separate and apart from but rather is inextricably linked to the economic system which created it. Therefore, any tax reform proposal must take into account the stress placed on those links.

We believe that Senators Bradley, Kasten and their supporters as well as the proponents and supporters of the other flat tax proposals have clearly articulated the tax reform goals towards which we all strive. Indeed, their efforts in bringing these issues before the national spotlight were Herculean. Their proposals formed the seeds from which our proposal grew. For this we are genuinely appreciative. However, we believe that our proposal would better satisfy the goals of tax reform without posing a serious threat to the economic health of our nation.

We recognize that data must be analyzed, that more work needs to be done. Therefore, we desire to work closely with this Committee and with the Department of the Treasury to explore more fully the economic and fiscal impact of this proposal, to determine the appropriate increase in the zero bracket amount and the personal exemptions and the parameters of each revised marginal tax bracket and its respective tax rate, and to see this proposal enacted into law before the close of 1985.

Again we thank the Senate Committee on Finance for the opportunity to present our views on this important topic.

STATEMENT OF ROBERT B. GRAHAM, SR., FOUNDER, COMMITTEE FOR CONSTITUTIONAL TAXATION, RICHBORO, PA

Senator **CHAFEE**. Mr. Graham.

Mr. **GRAHAM**. Thank you very much. Senators, I hope you will bear with me with my speech impediment. To my right here is Mr. Ellison. He's as associate from Maryland. I'm from Pennsylvania.

Senators, taxation without limitation is not only tyranny, it is extortion. Americans are victims of arrogance—an arrogant Tax Code, an extremely arrogant tax collection system, the IRS, and an arrogant Senate and Congress, and an arrogant electorate hell bent on getting more of what another man or woman earns.

Once you limit the ability of politicans to buy votes, you limit the incentive to give away people's rights. Senators, Congress never intended for the working man to bear the burden of the income tax. In 1789, there was a tariff tax on imports. This was the only tax. It was intended to have the wealthy foreigners pay for our Government.

If we, as Americans, must pay a tax to foreign lands, then so must they. It's called fair trade, not free trade or slave labor. Now we are subsidizing foreign imports with the jobs of American steel workers. We are subsidizing them with jobs of American clothing makers, shoe makers, and now auto workers to the detriment of all Americans. And this is unconstitutional.

Show us, please, where in the Constitution you have the right and the power to do this.

My friend told me on the way in here today that Senator Gephardt said on the Phil Donahue show just yesterday, "The sweat of Americans must be taxed."

Senators, is this the general feeling in the Senate? It is quite clear that what we need is Government obedience to the Constitution; not tax reform. When the quantity of law goes beyond the ability of human comprehension, it is nothing more than a tool of oppression.

Before you can reform the amount of taxes collected, it is incumbent upon you to reform the way the tax is collected. I ask you today—please tell me how I can fill out a 1040 form without waiving my constitutional rights? Second, is the filing of a tax return voluntary or mandatory? Wages are not taxable. Congressman Rosenthal stated in hearings that Americans voluntarily pay taxes on their wages. Is this true?

My question is: Where in the Constitution do you have the right and power to tax wages?

With all the pages of the IRS Code, thousands of them, there is not one definition of the word income. My seven recommendations—and I will go through them very briefly with you—is:

First, abolish the 16th amendment. For 137 years we did not have this tax, and the only financial problem with the Federal Government was what to do with the surplus.

Second, abolish the 17th amendment. For 137 years, we, the people, had control over the Senate. Today, the Senate is uncontrollable. I show you here an article that was in the Washington paper, the Washington Times, August 27, when the Senate unconstitutionally passed the TEFRA Act. Gentlemen, that's wrong.

Third, abolish the Federal Reserve Act of 1913. Printing of money is like pregnancy. Last year, you took in $400 billion in taxes, and you spent $1.1 trillion. So you printed the rest. Well, gentlemen, print it all, and don't tax anybody anything. It's ridiculous.

Fourth, and I strongly recommend this—embrace the Grace Commission Report. It seems as though that Government is always telling the people that they must sacrifice. The people are now saying to the Government, "It's time for the Government to sacrifice."

Fifth, declare a moratorium on all new legislation. And what I am saying there is before you pass one more bill, eliminate three of the old ones, starting with the 16th amendment and the 17th amendment.

Sixth, declare a moratorium on the public debt. You glibly say to the public that we owe it to ourselves. Well, if we do, then let's forgive ourselves.

Seventh, and most important, release—it is time, it is really time, Senators, to heal the wounds in this country—release all American political tax prisoners from U.S. prisons and do it immediately. These people are not criminals. They are the true patriots of this country. There are many real patriots, both men and women, who have been put in prison illegally. They were seeking redress of grievance and they were prosecuted by a tax-consuming Government attorney in front of a tax-consuming Government judge, and tried for breaking a law that was never explained by a tax-consuming legislature. Where are the citizens' right guaranteed in the Constitution to protect him from his Government?

Gentlemen, I'm closing with this. The original instructions—that's what these were—the Declaration of Independence, and the Constitution, and the Bill of Rights, they worked for 137 years until some rotten apples got into the pork barrel. These worms have grown to monstrous size in the last 71 years, 1 trillion pounds of Government waste, fraud, mismanagement, and corruption. All created by the twin evils—the 16th amendment and the Federal Reserve Act.

Senators, the judges of the Nuremberg trial stated to the defendants, and they were leaders, judges, and politicians—they stated: "That as the trusted leaders, the judges and the politicians, you knew or should have known that what you were doing was evil and wrong."

Senator **CHAFEE**. Well, thank you very much.

Mr. **GRAHAM**. I'm not finished, sir. May I please finish? I have only a little bit more.

Senator **CHAFEE**. Yes. Why don't you take another minute.

Mr. **GRAHAM**. Thank you, sir.

I'm a citizen of the United States and I'm saying to you in no uncertain terms that you are violating the Constitution of the United States, and one day you will be held accountable for this criminal action.

Our forefathers are turning over in their graves today because of Government extortion, fraud, and corruption, and abuse, but I'll bet they are anxiously awaiting your arrival.

If the Ten Commandments were enough moral law for the Lord, why aren't the 10 amendments enough law to control Government. And if 10 percent tithe was good enough for the Lord, why can't we limit Caesar to 10 percent. Taxation without limitation is not only tyranny, sir, it is extortion. And I implore you—I will not take time to read the bottom part, but I have been prosecuted once for appearing in front of the Congress. I implore your help right now. The Government has done everything, including putting plants in the juries. It's just horrible what they are doing to enforce an unfair tax system. It's time to heal these wounds. There are 20 million Americans not filing today.

Senator **CHAFEE**. Thank you very much, Mr. Graham.

[The prepared written statement of Mr. Graham follows:]

HEARING

BEFORE THE

UNITED STATES SENATE

COMMITTEE ON FINANCE

TAX REFORM HEARINGS

TESTIMONY OF ROBERT B. GRAHAM SR.

Gentlemen, my name is Robert B. Graham Sr, I come form Holland, Pennsylvania which is north of Philadelphia.

In the Declaration of Independence, the foundation upon which our Country was built, it declares the reasons and causes which impel us to the Seperation, it states, that we were endowed by our creator with certain unalienable Rights. It goes on to state, "In every stage of these Oppressions we have Petitioned for Redress in the most humble Terms: Our repeated Petitions have been answered only by repeated injury" and "For imposing Taxes on us without our consent". The original Constitution spells out the **limited** powers of the government, and the Bill of Rights, the first ten Amendments guarantee the Rights of citizens.

Is it possible that one day, you the entrusted stewards of the Country will be asked by our Creator, "I gave you the ability to rise to the position among your fellow man to the trusted position of Senator, you were placed in charge of the most sacred document ever written since the Bible. What did you do to guard the Constitution from evil and distruction?" "Remember the day I sent a man to warn you about the mismanagement by you and your collegues"? "Did you hear what he said"? "What did you do about what he said"?

I testified before Congress, at Congressman Rosenthal's Committee on Government Affairs, shortly thereafter, the Internal Revenue Service **recommended** a grand jury investigation be conducted **to develope evidence** of criminal violations against me (see exhibit 1).

In the I.R.S. letter from Mr. Gaston, he **directs** the Asst. Attorney General of the United States **to develope** this **evidence** because Graham gained country wide coverage based on **his appearance before Congress** seeking Redress of Grievance. Gaston further states, "**For these reasons,** a grand jury investigation **is necessary** and appropriate and these cases have significant **deterrent** potential". As you can see by the letter, Mr. Gaston is the Regional Counsel for the I.R.S. In his letter he notes, "the United States Attorney in Philadelphia **has expressed a commitment** to investigate **illegal** tax protesters. Senators do you know what an "illegal tax protester" is and what is the difference between them and a "legal tax protester"? I'm appearing today before the Senate and I ask for your protection, for I am afraid of my government. I sincerely hope that History does not repeat itself. My government violated my First Amendment Right, for indeed, if the United States government can suppress the rights of one, the freedom of all is jeopardized.

We, my wife and our seven children and eight grandchildren were put through the ordeal of a criminal trial [38 counts] **exactly as the I.R.S. had instructed** the Asst. Attorney General of the United States, but the also tried me for "Willful failure to file" for I had exercised my Constitutional Rights on a tax return. In spite of the Judge and the Asst. U.S. Attorney, I was able to explain to a jury of 12, that I was "knocking on the government's door and asking them **"How do you fill out a 1040 form without waiving your Constitutional Rights?"** The government has never answered.

Enclosed is a letter [exhibit 2] from an I.R.S. agent to me and my reply to him, as of today 9/20/84 the I.R.S. has not told me "How do you fill out a 1040 form without waiving your Consitutional Rights"? Senators it is incumbent upon you, in fact **it is your duty** to tell the American people how it can be done, and if it can't be done, there should be a "Warning" on the form, you put warnings on cigarette packs in fact you now have four different warnings. This "1040 Warning" should state, "I as an American **am willing** to waive my Constitutional Rights." for identification purpose you could call it the "Graham Warning" for the innocent and unsuspecting, just like the "Miranda Warning". The Constitution and Bill of Rights guaranteed to the citizens protection **from** their government.

During my trial, both the Judge and U.S. Attorney denied the admission into evidence of the Constitution as one of my "reliance documents". Most of the over 100 "reliance documents" were denied admission as evidence. Furthermore, The Citizens Guide To Individual Rights Under the Constitution of the United States of America - (Prepared by the Subcommittee on Constitutional Rights of the Committee on the Judiciary - United States Senate) was first allowed - then after a note which I saw passed to the Judge - he then denied its admission - then after a heated debate, we were compelled to make an "offer of proof", only then was this "reliance document" finally admitted. If my trial is a sample of U.S. government justice, this government is no different than the Russian or communist governments, they are all tyrants, hell bent on keeping a corrupt system of special interest groups controlling the producers and collection extortion money from them for protection. If "Taxes are what we pay for a civilized society" - **Then taxes without limitations is extortion!**

After the trial, the Asst. U.S. attorney continued his committment, he indicted other persons who had attended Constitutional meetings with fellow citizens. Many people implored me to intercede on their behalf to get "back into the system" even though they knew they would never feel right about it. Enclosed is the three page letter I wrote to the U.S. Attorney and the short one paragraph reply (Exhibit 3). He later told me personally, "I'll get them all". How do you talk or reason with such a "committed" person as this U.S. Attorney. Remember the Declaration of Independence saying "In every stage of these **Oppressions** we have been answered only by **repeated injury.**

WHERE DOES A CITIZEN GO TO GET REDRESS OF GRIEVANCE AGAINST HIS GOVERNMENT WITHOUT BEING PUT ON TRIAL? The U.S. Attorney can only defend the government and they have repeatedly abused and used the grand jury for nothing more than an "automatic" rubber stamp. The Judges instruction are totally biased in favor of the government. And in petite juries, the Judges demand that the jury accept the law as **he gives it to them,** they must accept **his opinion** of the law, this is a direct violation of the Constitution. When any government must employ these tyranical tactics to collect taxes, that government's tax program is in deep trouble and must be stopped.

Gentlemen, Americans from every state in the United States, by reports in the media, there are more than 20 million American who are either not filing tax returns or filing as the government calls them, "Constitutional returns". As an Investment Advisor I receive reports that the "underground economy" has doubled from last year. It seems that more and more Americans are perceiving your tax system to be totally corrupt, loaded with goon-squad hit-men (from watching too much T.V. cop shows), this government agency (I.R.S.) are like uncontrolled bounty hunters, who take a special delight in abusing and harassing their victims who are their fellow citizens.

Many Americans remember your passage of the "Black Lung Bill", that's the legislation with which you made yourself almost tax-free.

The leader of this very Committee, Sen. Dole, brazenly proclaimed that he was above the Constitution when he and his fellow Senators passed the "TEFRA" legislation in an unconstitutional manner. I and many other Americans filed suits to stop this violations or our Constitution and Federal Judges ruled in favor of the government against the Constitution.

I pray that Mr. Dole is not elected to any public office and that he be tried for TREASON and Violation of his OATH OF OFFICE, and IF FOUND GUILTY, for punishment he be made to publicly apologize for his unconstitutional actions. If you don't have to obey Article 1, Section 7, Clause 1 of the Constitution, why then do the citizens have to obey the Sixteenth Amendment, which was reported by a Mr. Red Beckman in his book, Born again Republic, that the 16th Amendment was never ratified or signed by a President. Don't you realize that if these American people who have researched this material might be right, and IF they are, are you not again violating the Constitution or the United States, which I believe you took an OATH to defend? Don't you care? Are you above the Constitution?

Before we can ever have any honest tax-reform we must first have government-reform. I have enclosed two white-papers on the "Bank Crisis" - how and why it started, It explains in detail who is profiteering from the crisis. It seems that a Senate Investigation on Senators St.Germain and Garn, for their involvement into this government fraud is imperative as a start in restoring honesty to government. In particular this investigation must include their involvement with the passage of the "Monetary Control Act of 1980" and "the Omnibus Banking Bill".

These white-papers (Exhibit 4 - 5) were written and published by me. My information came from sources, such as: 1984 Statistical Abstract of the U.S. Department of Commerce which informed me:

TABLE 1

FEDERAL TAX COLLECTION
(Billions of dollars per year)

Year	Income Tax Collected	Social Security Tax Collected
1950	$ 15.7	$ 4.4
1960	40.7	14.7
1970	90.4	45.3
1980	244.1	150.6
1985	328.0	260.0

Since 1960 social security tax collections have trebled each decade while income tax collections have more than doubled. A disasterous record, since 1950, is in a capsule form in Table 1. A little extrapolation tells us that early in the 1990's social security tax collection **will exceed** income tax collection, if in fact either one will be collectable then.

The final political "solution" will be to subsidize social security from "general tax revenues" i.e., from the government printing presses. This item alone can bankrupt the federal government which would cause hyperinflation and the total destruction of the unbacked paper dollar and all paper dollar-denominated debt securities.

It took 200 years (to 1976) for the federal debt to reach $600 BILLION, but only seven more years (to 1983) to reach $1,200 BILLION (it now stands at $1.5 TRILLION). Similarly, it took 200 years for federal spending to reach $300 Billion-plus-per-year, but only six years to reach $600-Billion-plus-per-year (1981). This year it is budgeted at $854 BILLION. It took 199 years for the U.S. money supply to reach $1 TRILLION but took only seven more years to reach $2 TRILLION (a 100% increase); it now stands at $2½ TRILLION!

And now the Treasury is talking about **changing the color of the money!** You have passed legislation authorizing the establishment of "**Concentration Camps**" in the United States for illegal aliens and **disidents.** Would a citizen seeking Redress of Grievance be a disident?

After re-reading the Declaration of Independence, I am convinced that everyone of the repeated Injuries and Usurpations enumerated therin have once again been perpetrated upon "WE THE PEOPLE of the UNITED STATES", by our own government.

You are now today holding these hearings on "Tax-reform", how can you reform a tax-system that that the I.R.S. controls? Enclosed is a letter from a large corporation informing all employees; "that tuition reimbursement is taxable income" this means that in order to increase you ability to function in the U.S., thanks to Congress, employees will have to take a pay cut (see Exhibit 5). People will not work overtime because it increases their taxes, and now in you infinite wisdom you are going to tax "schooling". What next?

I am afraid for my country, Senators, when the Grace Commission Report of Waste and Fraud in government reveals that almost 2,500 government agencies are presently wasting over $450 Billion of the taxpayers money and you do nothing about it, something is wrong with you. I have presented the "Grace Report" to you if you need more copies call Mr. Grace or me and we will be glad to furnish them. Before you increase taxes one "zink" cent, eliminate this waste. If you can't do the job, QUIT!

THEREFORE, for all the reasons mentioned before and you know thousands more. I suggest in the strongest terms that the following suggestions be adopted and implemented immediately:

1. ABOLISH THE 16TH AMENDMENT.

For 137 years we did not have this tax and the only financial problem with the Federal government was what to do with the SURPLUS from taxes. Since 1913 and the 16th Amendment we have taxed the U.S. citizen to pay for 2 World Wars, Korea, Vietnam, both sides of 116 other wars and are now paying taxes to support a pending nuclear holocaust.

2. ABOLISH THE 17TH AMENDMENT.

For 137 years we had States that elected and controlled their Senator, now no one controls the Senate. They are doing things that are unconstitutional and they must be placed under the control of the State legislators, who clearly reflect the will of their Constituency.

3. ABOLISH THE FEDERAL RESERVE ACT OF 1913.

The Federal Reserve is a private corporation which is violating Article 1, Section 10 of the Constitution. We can not have honest government with dishonest money. The Federal Reserve has never been audited by an outside source. There must be a complete audit of Fort Knox by outside sources. Based upon politician's past performance, most people do not trust politicians. They feel that special interests, like the Fed., have bought and paid for their elections.

4. EMBRACE THE GRACE COMMISSION REPORT.

The waste and fraud in this report is a true picture of your worth to the taxpayer. Can't you control anything except the taxpayers pocketbook? USE THE REPORT TO ASSIST IN IMPLEMENTING FARREACHING REFORMS!

5. DECLARE A MORATORIUM ON ALL NEW LEGISLATION.

Until the deficit problem has been solved do not approve any legislation, and do not increase the "debt ceiling" for your past performance would indicate that you believe the sky the limit. The Senate is uncontrollable in their wild spending they remind me of a "drug addict". These "spending addicts" in the Congress must go on a "cold turkey" austerity program to cure their wasteful spending sickness for the good of the country. Government is always asking the taxpayer to "sacrifice". The taxpayer is asking the government to "sacrifice". We the taxpayers know that there is a big difference between Country and government. Taxes caused one revolution in the United States and, maybe, your new taxes are on the way to formenting another.

6. DECLARE A MORATORIUM ON THE PUBLIC DEBT.

Since we owe this debt to ourselves, let's forgive ourselves of the debt and the interest on the debt, for the good of the country. With the new Treasury money pay off all citizens who bought this debt in an orderly fashion.

7. RELEASE ALL U.S. POLITICAL TAX PRISONERS FROM U.S. PRISONS. IMMEDIATELY !

Since you have not defined the word "income" and what is meant by "from the source" and is that different and in what way from "on the source". The executive branch and the judicial branch have conspired to indict then incarcerate brave Americans because the legislative branch of government are too cowardly to defend the Constitution. There are many real patriots, both men and women, who have been put in prison illegally. They were seeking "redress of grievance" and they were prosecuted by a tax-consuming government Attorney in front of a tax-consuming government Judge and tried for breaking a alleged law never explained by a tax-consuming legislature. Where are the citizens Rights guaranteed in the Constitution to protect him from his government?

It is time to heal the wounds.

By the implementation of the 7 name items in my Petition for Redress of Grievance, you will be restoring the United States to its original glory days. This action on your part will immediately institute the finest day care centers in the world, the home with a mother in it. Most women do not want to leave their children, they are working to survive and their children are paying the price which is too expensive. WE THE PEOPLE would again realize what our forefathers accomplished when they gave us a Republic as a form of government. We would tell the world that "We are a Born-Again Republic".

The original instructions, the Declaration of Independence, Constitution and Bill of Rights, worked for 137 year, until some "rotten apples" got in the "pork barrel". These worms have grown to monster size in the last 71 years, a Trillion pounds of government waste, fraud, mismanagement and corruption, all created by the "Twin Evils", the 16th Amendment and the Federal Reserve Act. The Judges at the "Nurenberg Trials" stated to the defendants that they as trusted leaders, judges and politicians, knew or should have know that what they were doing was evil and wrong. I as a citizen of the United States am stating to you in no uncertain terms that you are violating the Constitution of the United States and one day you will be held accountable for your criminal actions. Let my warning to you be recorded as a testimony to your past and may your future actions offset your past misconduct. Our forefathers are turning over in their graves today because of government extortion, fraud, corruption and abuse, but I'll bet, they are anxiously awaiting your arrival.

If ten Commandments were enough moral law for the Lord, Why then aren't 10 Amendments enough law to control government, and if a 10% tithe was good enough for the Lord, **why can't we limit Ceasar to 10%?**

TAXATION WITHOUT LIMITATION IS NOT ONLY TYRANNY, IT IS EXTORTION!

Now I realize that this is a bad time to ask for a personal favor, but I am terrified and frightened, because of my appearance today and my petition for redress of grievance. I fear that I will once again be prosecuted for appearing in front of Congress, I am asking for your protection of my Constitutional Rights. It is indeed a sad day in America when a citizen feels the "chilling effect" of the loss of his First Amendment Right by a vindictive U.S. prosecutor.

Respectfully Submitted,

Robert B. Graham Sr.
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2/3/82

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January 19, 1982

MA:CT:GJ
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Honorable Glenn L. Archer, Jr.
Assistant Attorney General
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Re: Grand Jury Investigation
Robert B. Graham, Sr.
Joseph Balchaitis

LPM
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DEPARTMENT OF JUSTICE
22 FEB 1982
RECORD

LPM

Dear Mr. Archer:

3

We recommend that a grand jury investigation be conducted to develop evidence of criminal violations of the Internal Revenue Code by the above-named individuals. This referral is within the purview of 26 U.S.C. § 6103(h)(3)(A).

Criminal

Robert Graham is the leader of a tax protester movement in the greater Philadelphia area. He and his followers have gained prominence in the local and national news media. Also, Graham gained country wide coverage based on his appearance before Representative Rosenthal's Committee on Government Affairs.

Graham and his followers are now promoting a variety of tax protester schemes at seminars conducted throughout the Philadelphia area. Graham charges $5.00 per person for his seminar and another $12.00 for his tax package. The "Graham Package Returns", in addition to making Fourth and Fifth Amendment objections, have the following characteristics: (1) "Filed in Good Faith" where the DLN goes; (2) Note: I am fearful of the IRS in the signature block; (3) Names of dependent children on the proper line; (4) Wife claimed as exemption with married filing separate status, and; (5) an affidavit signed by William Kirby, Graham's assistant. For 1980, there were 131 "Constitutional Returns" filed with the Philadelphia District, many of which were "Graham Packages". The other six individuals named above, in addition to filing "Graham Package Returns", are all believed

(Exhibit 1)

Registered
377464

to be vocal advocates of the program with their fellow employees and/or business associates.

Based on past experience with Graham and others, the District Director has encountered lengthy delays in summons enforcement proceedings and the filing of FOIA requests.

For these reasons, a grand jury investigation is necessary and appropriate since it is apparent that the administrative process cannot develop the relevant facts within a reasonable period of time and these cases have significant deterrent potential.

It is proposed that the grand jury investigation be geared towards possible prosecution for conspiracy to defraud the United States by disrupting the lawful functions of the Internal Revenue Service (Title 18, Section 371); wilful attempted evasion of the taxes of others (Title 26, Section 7201); and wilfully aiding and assisting in the preparation and presentation of materially false income tax returns in violation of Title 26, Section 7206(2). This grand jury investigation would be similar to that conducted in San Diego, California, which led to the successful prosecution of William Drexler, Sr. and his associates.

It is noted that the United States Attorney in Philadelphia has expressed a commitment to investigate illegal tax protesters for aiding and assisting others in evading taxes.

We note that jurisdiction over the tax aspects of the proposed grand jury investigation remains with the Tax Division of the Department of Justice. Therefore, a subseqeunt report to the grand jury made by agents of the Internal Revenue Service assigned to assist Government attorneys in the performance of their duties will be forwarded to this office for our views and analysis concerning the merits of any prosecution cases and then will be sent with our comments to you.

The referral of this matter is duly authorized and the assistance of the Internal Revenue Service personnel will be furnished upon request of the attorneys for the Government.

In accordance with the revised Rule 6(e) of the Federal Rules of Criminal Procedure, dated October 1, 1977, the following individuals in the Office of Regional Counsel, Mid-Atlantic Region, are identified as having participated in the evaluation of this request for grand jury assistance, and as having access to the enclosed materials:

David E. Gaston, Regional Counsel
Richard A. Francis, Deputy Regional Counsel (Criminal Tax)
Debra Szabo, Secretary

Very truly yours,

David E Gaston

DAVID E. GASTON
Regional Counsel

RAF

ROBERT B. GRAHAM SR.
46 Lark Drive
Holland, Penna., 18966
215 - 355 - 5660

9/5/84

Mr. Frank Bucci
Internal Revenue Service
District Director
P.O. Box 12040
Phila., Penna., 19106
215 - 597 - 4114

DEAR MR. BUCCI;

On August 16, 1984, I was shocked and surprised to receive eight (8) of my tax returns and the usual I.R.S. form letter from a Norman E. Marriel. You mention in your letter, "It has come to my attention", did Mr. Norman E. Marriel inform you that my returns are "not acceptable"? You refer to, "We find", would you please inform me of all persons and their rank within the I.R.S. who helped you reach your decision that my forms were not acceptable. Is Mr. Marriel conducting a separate investigation of me? Is he or anyone else conducting a criminal investigation of me? How many investigations of me are going on at this same time? Mr. Marriel has threatened me with Criminal prosecution and has not answered my letter to him.

You state, "In order for a return to be processed, it must have identifying information such as name, address and social security number. It also must provide enough financial information to compute your correct Federal tax liability and must be signed under penalty of perjury". Since all eight of my "filed" tax returns contain my name, address and social security number plus enough financial information to compute my correct Federal tax liability, the only thing not resolved is "the signing under penalty of perjury". If this is correct, please inform me, "How can a person file a tax return without waiving their Constitutional RIGHTS?"

You state on page 3, "the filing of returns is mandatory", in the very next paragraph your state, "The income tax is voluntary in the sense that the great majority of taxpayers are willing to compute their own tax liablities when they prepare and file their returns". I am totally confused for if the filing of a tax return is "mandatory" then there must be a "Warning" on the tax form stating that the information can be used in a criminal case against you, therefore, you are willing to waive your Constitutional RIGHTS. Are you or the I.R.S. mandating that I must waive my Constitutional RIGHTS?

I want to cooperate with your agency completely but I do not want to waive my RIGHTS. If you are interested in determining my civil tax liability you will present me with Immunity from any criminal liability. You know I am fearful of your agency because of their past performances. Please get me Immunity as a "show of good faith" on the part of the I.R.S. I will not waive my RIGHTS, and I must as an American defend these RIGHTS!

I would appreciate your taking the time to put your answer in writing before 9/14/84 and reschedule my appointment, as we had agreed, until after my Appeal has been heard. Thank you.

Sincerely,

Robert B. Graham Sr.

(Exhibit 2)

Internal Revenue Service

District
Director

Department of the Treasury

P. O. Box 12040, Philadelphia, PA 19106

Robert B. Graham
46 Lark Drive
Holland, Pa. 18966

Person to Contact:
Frank Bucci
Telephone Number:
(215)597-4114
Refer Reply to:
E:1340:FB
Date:
August 30, 1984

DEAR MR. GRAHAM,

Since our last meeting on June 15, 1984, it has come to my attention that the forms 1040 that you submitted for the years 1976 through 1982 are not acceptable. We find they do not comply with certain Internal Revenue Code requirements. In order for a return to be processed, it must have identifying information such as name, address and social security number. It also must provide enough financial information to compute your correct Federal tax liability and must be signed under penalty of perjury. In order to continue with the civil settlement of your Federal Income Tax liability for the years 1976 through 1982, I am requesting information disclosed on documents that you previously submitted. Before doing so, I would like to respond to certain questions that you posed at our last meeting. As we noted during our discussion at that time, the following information has been explained to you numerous times in the past, however I will respond to your questions to allay any confusion you may have about the requirements of the Internal Revenue Code of 1954.

(Exhibit 2)

Section 61 of the Internal Revenue Code sets forth the general definition of gross income. Gross income means all income from whatever source derived, unless excluded by law.

Internal Revenue Code section 6012 and the Treasury Regulations thereunder set forth the persons required to make returns of income, as defined in section 61 of the Internal Revenue Code of 1954.

Internal Revenue Code section 7701(a)(1) defines a person as "The term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation." A United States person is defined as a citizen or resident of the United States.

Internal Revenue Code section 6011 gives the Secretary of the Treasury the authority to prescribe regualtions as to the requirements of a "return" or "statement" to be made by any person made liable for any tax imposed by Subtitle A of the Internal Revenue Code of 1954, which became law upon enactment of Public Law 591, 83d Congress, approved August 16, 1954.

A filing of a return or statement is mandatory for persons who are required to make such returns as set forth per the Internal Revenue Code of 1954 section 6012. The acceptable form of the return is prescribed per the Treasury Regulations under section 6011 of the Internal Revenue Code of 1954. These provisions are bolstered by section 7203 of the Internal Revenue Code of 1954, which makes the willful failure to file an income tax return a crime.

The filing of income tax returns and the payment of income taxes are not voluntary in the sense that an individual may choose whether he will file a return and pay the tax he owes. Sections 6011 and 6012 of the Internal Revenue Code of 1954 require the filing of returns and payment of income taxes due from taxpayers. Hence, the filing of returns is mandatory.

The income tax system is voluntary in the sense that the great majority of taxpayers are willing to compute their own tax liabilities when they prepare and file their returns. Their actions in filing returns and paying income taxes are, however, required by law.

In order to determine your correct civil tax liability for the years 1976 through 1982, please submit the following information:

1976

1) Identify by amount and source the Gross Income for the Graham Agency
2) Distinguish between Gross Income for the Graham Agency and corporate Gross Income
3) Cancelled checks and invoices/receipts for the Graham Agency business expenses
4) Cancelled checks and invoices/receipts for personal expenses (itemized deductions)
5) Cancelled checks and invoices/receipts for Keough Plan including copy of plan
6) Ages, Gross Income, Educational status of children

1977

1) Identify by amount and source the Gross Income for the Graham Agency
2) Distinguish between Gross Income for the Graham Agency and Corporate Gross Income
3) Cancelled checks and invoices/receipts for the business expenses of the Graham Agency
4) Identify by source and amount the Gross Income for Church of Love
5) Distinguish between Gross Income for the Church of Love and corporate Gross Income
6) Cancelled checks and invoices/receipts for business expenses of the Church of Love (1099's for commission expenses)
7) Cancelled checks and invoices/receipts for Personal expenses (itemized deductions)
8) Documentation of short term capital loss carryover for 1971
9) Ages, Gross Income, and Educational status of children

1978

1) Identify by amount and source the Gross Income of the Church of Love
2) Distinguish between Gross Income for the Church of Love and corporate Gross income
3) Cancelled checks and invoices/receipts for the Church of love business expenses
4) Cancelled checks and invoices/receipts for personal expenses (itemized deductions)

1979

1) Identify by amount and source the Gross Income for the Insurance and Investment Counselor business
2) Distinguish between Gross Income for the Insurance and the Investment Counselor business and corporate Gross Income
3) Cancelled checks and invoices/receipts for the business expenses of the Insurance and Investment Counselor business
4) Cancelled checks and invoices/receipts for personal expenses (itemized deductions)
5) Ages, Gross Income, Educational status of children
6) Dividend income for yourself and/or spouse

1980

1) Identify by amount and source the Gross Income of the Insurance and Investment Counselor business
2) Distinguish between Gross income for the Insurance and Investment Counselor business and corporate Gross Income
3) Cancelled checks and invoices/receipts for the business expenses of the Insurance and Investment Counselor business (including 1099's for commission expense)
4) Cancelled checks and invoices/receipts for personal expenses (itemized deductions)
5) Ages, Gross Income, and Educational status of children
6) Dividend Income for yourself and/or spouse

1981

1) Identify by amount, and source the Gross Income for the Insurance and Investment counselor business
2) Distinguish between Gross Income for the Insurance and Investment Counselor business and corporate Gross Income
3) Cancelled checks and invoices/receipts for the business expenses of the Insurance and Investment Counselor business
4) Cancelled checks and invoices/receipts for personal expenses (itemized deductions)
5) Ages, Gross Income, Educational status of children
6) Dividend income for yourself and/or spouse

1982

1) Identify by amount and source the Gross Income for the Insurance and Investment Counselor business
2) Distinguish between Gross Income for the Insurance and Investment Counselor business and corporate Gross Income
3) Cancelled checks and invoices/receipts for the business expenses of the Insurance and Investment Counselor business
4) Cancelled checks and invoices/receipts for personal expenses (itemized deductions)

General Information

1) Bank Statements, Deposit slips and cancelled checks for the following bank accounts for the period 1976 through 1982

1st National Bank of Newtown	A/C # 112-612-7
Girard Bank	A/C # 3-946-514
Trevose Federal Savings	A/C # 1388720
Trevose Federal Savings	A/C # 1381844
Cheltenham Bank	A/C # 130024

2) Statements, correspondence and any transaction records with Deak and Co. for the period 1976 through 1982

3) Statements, correspondence and records for foreign bank accounts or foreign currency transactions for the periods 1976 through 1982

4) Advise as to whether you will consent to secure information on accounts in your name or the name of your business regarding any Foreign Bank Accounts/Foreign Currency Transactions.

Please respond to the information requested by September 14, 1984. An appointment has been scheduled for you on this date at 10:00 A.M. in the Jenkintown Internal Revenue Service Office, located at Noble Plaza, 601 Old York Road, Jenkintown, Pa.. Failure to respond to this appointment will be considered as your refusal to provide the information.

If you have any questions, please contact me at the above listed phone number.

Sincerely yours,

Frank Bucci
Internal Revenue Agent

ROBERT B. GRAHAM SR.
46 Lark Drive
Holland, Pa., 18966
215 - 355 - 5660

March 22, 1984

Exhibit #3

Mr. Edward S. G. Dennis, Jr.
United States Attorney
Eastern District of Pennsylvania
3310 United States Courthouse
Independence Mall West
601 Market St.
Phila., Penna., 19106

Dear Mr. Dennis;

On Thursday, March 15, 1984, I spoke to Edward Borden (ASUA) and Jack Bell (C.I.D. - I.R.S.), regarding the possibility of a negotiation of some reasonable nature which could enable other American citizens ardently involved in what is now tagged a movement toward Constitutional taxation, to re-enter the system in a less spectacular manner than I did myself. Mr. Borden and Mr. Bell do not seem interested in peacefull negotiations. It is all too clear that public flogging is what the Justice Department and the I.R.S. has determined to be the cure necessary to purge the spirit of so-called dissenters. However, history has shown that to continue in this vein can only destroy the very fibre of our nation.

It was never my intention to do anything but stress to our government in various ways that we are on a dangerous path to the ruination of our Nation of Free People.

It can serve no usefull purpose to continue to cause prosecutions, financial ruin and imprisonment to individuals who are inclined to make restitution and continue on with their lives as well as they can. Anyone involved in the tax movement in the United States knows that the governments vengence is like the blade of a guillotine, sharp, swift, and deadly. Through secretly misled grand juries, overzealous prosecutors, and biased and prejudiced courts, the battle for Constitutional taxation took a swift turn for the worse. Speedy trials resulted in prison terms for most and probation for few, with occasional acquittals. A good faith effort to exercise their Constitutional RIGHTS guaranteed to them at the birth of this nation, was for many, stopped dead in its tracks, and the prosecuted became prisoners of war, whether inside or outside the jails.

I am taking a calculated risk that I will not be put in prison for writing this letter.

I have been ordered not to talk publicly against the I.R.S. or "interfere" in it's operation. Yet by way of explanation I must refer to the philosophy of the movement as well as to clearly express my motivation toward peaceful negotiations. I appeared as a witness at the trial of a so-called 5th Amendment filer on March 15, 1984 - in Federal Court (3rd District - Judge Pollock, 13th floor). At that [trial] I was Ordered by the court to tell the jury that I was convicted of conspiracy to defraud the U.S. government, and to tell the jury that I was found guilty of aiding and abetting the filing of false documents (inaccurate as charged but convenient to prosecutor's intent) but was forbidden to tell the jury that I was found 'not guilty' of willful failure to file, since in fact I filed a 5th Amendment tax return, the same as the current defendant.

All the charges and verdicts were part of the same trial. Yet I was forbidden to tell the jury I was found 'not guilty' of willful failure to file, I was repeatedly warned by Judge Pollock that I would be found in contempt and sent to jail.

I am still shaken by my fury at this judge's violation of my First Amendment RIGHT. The defendant in this trial was found guilty on five counts of the same charge which I was acquitted of, on September 16, 1983 and this jury never heard the whole truth, which is typical in tax cases.

It doesn't take 'public execution' by a government firing squad to make me realize that these seekers of true freedom will have to pay for their crimes of talk or for seeking redress of grievance against a voluntary compliance system of taxation which persecuted non-volunteers.

I feel I must intercede for those who believed and still believe that this nations founders never meant for the working man to bear the burden of oversized government, that is mired in overwhelming debt it has incurred and continues to incur; to intercede for those who believed and still believe that this nations founding fathers provided a law for innocent non-criminal citizens to protect themselves from being entrapped into a crime of perjury as a result of signing a tax form - called both "voluntary" and "compliance" (subject to the whims of bureauocratic scrutiny and approval), that vehicle was and still is the 5th Amendment of the United States Constitution.

I am still concerned that this agency of government is endowed with certain unlawful advantages which serve to intimidate, incriminate and incarcerate those who would request explanation of it's origin and it's power. Despite a firm belief that they have entered into a 'good faith' effort to bring about some semblance of sanity to our system of taxation. There are some Constitutionalists who are aware that the answer is not to be found in a jail cell. It is not to be found in the courts at this time. Perhaps the answer is not to be found at all.

My purpose for contacting you is to create an atmosphere of negotiation for the brave Americans who have chosen to rejoin the system yet are terrified of I.R.S. retaliation, of prosecutorial vindictivness, injustice in the courts and more governmental control - years in prison or probation, for exercising a Consitutional RIGHT!

These recalcitrant taxconformers stand ready to enter into a period of compliance, albeit non-voluntary, but nontheless, compliance.

They seek a method which could be more reasonable than indictment or (illegal) informations, trial, followed by prison.

Thomas Jefferson would cringe at this and so do I, but I am willing to give negotiations a chance and hope and pray for our lost Constitution.

I have been outspoken in this cause and now feel somewhat disposed to plead in behalf of those individuals who are about to be engulfed in a quagmire of litigation and senseless torture as punishment for their good faith conscientious stand in behalf of Constitutional taxation. Although you or others may not admire the deeds of those Americans, you must admire their courage and openness and you should appreciate that what they did was to make an honest, forthright effort to call attention to the plight of all hard working Americans.

I personally have no objection to paying legal taxes and realize that as the government states on the treasury buildings "taxes are the price we pay for a civilized society". This is not to say I have changed my thinking. I still contend, if this nation supports government tyranny, civilization as we know it is lost.

I look forward to your assistance in this matter and pledge myself to help you as well as those who seek my intercession to uncomplicate the predicament they now find themselves in. In the interest of Justice and to restore the faith and confidence of the American people in their government, I seek to save incalculable manhours in [illegible]. I.R.S. investigations, Justice department prosecutions, prison maintenance and the rehabilitation of Citizens of this Country who never had anything but America's best interest at heart. They saw their duty and they did it. God bless them and the Americans who anxiously await your answer to this letter. It's time to try to heal the wounds! God bless America.

Sincerely,

Robert B. Graham Sr.

Copy to:

President of the United States
Congress
News media

U.S. Department of Justice

United States Attorney
Eastern District of Pennsylvania

3310 United States Courthouse
Independence Mall West
601 Market Street
Philadelphia, Pennsylvania 19106

JJR:sw

April 16, 1984

Mr. Robert B. Graham, Sr.
46 Lark Drive
Holland, PA 18966

Dear Mr. Graham:

With regard to your concern about those individuals who may be the subject of criminal investigations as a result of your advice in resisting the payment of federal income taxes, please be advised that our office considers these matters on a case by case basis. If anyone should contact you concerning their tax situation you would be well advised to have them consult with their attorney.

Sincerely,

James J Rohn

James J. Rohn
Acting United States Attorney

THE PRICE OF IGNORANCE IS ALWAYS TOO HIGH !

(Exhibit #4)

The other day, while having lunch with my friend, we reflected on his comments and opinions of 1976. Though pessimitic at that time, his statements at that time included...U.S. Steel would be laying-off half of their employees within five years because they could not or would not compete with foreign steel companies, U.S. and world banking industry is in terrible shape due to the increase in OPEC deposits; he said they (the banks) were bankrupt and they would not be able to recover, because this time there is no gold as there was in 1929, because the cupboard is bare, except for 138 million ounces of silver. He believes Ed Durell's investigation, that there's no gold in Fort Knox. He said if the government had gold in Ft. Knox they would prove it, by showing the critics and doubters the gold.

He said to put things in the right perspective, the day is coming when unbacked paper dollars will not be accepted for anything. You will need either gold or silver or some other commodity. The government's and banker's 'confidence game' is almost over.

When I asked him to explain, he stated, "back in 1964, you could buy a gallon of gas for a quarter, and you still can today - if it's a 1964 quarter. Only today, you'll get change - Gas at $1.12 minus $1.48 (cost of a silver quarter) equals 36¢ change". "Nothing really changes in the real world". He told me his father bought a new chevy in 1940 for $800, and that you can still get a new chevy for 800 Silver Dollars (800 x $12. = 9,600 paper dollars). My friend pointed out to me that in 1964 you could exchange a paper dollar for a silver dollar, now it takes 12 paper dollars to get one silver dollar. He said this proves people are losing faith in paper dollars and are gaining faith in silver dollars because neither the government nor the Fed can print "pre-1964" silver dollars.

I asked him, "How did this happen to the American people? He replied, "Word-speak" such as "It's like money in the bank." & "As sound as a dollar". Americans love their country and they want to believe the best about their fellow Americans whom they elect, but they confuse country with government and that is a terrible mistake.

To illustrate this point, he said, the first clich'e has been used for generations to describe the safety of various deals. It's use creates immediate confidence and security. For no-one on the outside could break into a bank vault undetected, but this is an inside job by the bankers and their friends [the politicians]; who have the keys to the your vault, your life, your liberty and your property. He added the old saying of "he who has the gold makes the rules", since the bankers have the gold, and also control the politicians who change the rules, it appears hopeless.

The second clich'e has been used for generations to describe the safety of money. The printing of paper money by other than the Federal Reserve is called counterfeiting, but the Feds call the printing of unbacked paper money "increasing the money supply".

Well I asked, "if they have the gold and make the rules, what happened; where and when and how did the bankers go wrong?" There is much talk about a banking crisis, is it true? ...is there a crisis? My friend stated, the impending worldwide banking crisis that faces us today is for real. It had it's begining with Nixon closing the 'gold window', which started the oil embargo of 1973-74, we saw the oil producing countries, with the help of the American Oil Companies, quadruple the price of oil. They formed a cartel called OPEC, led by Saudi Arabia with production close to 10 million barrels per day, and a total production of over 30 million barrels per day by the entire cartel. The price increase meant an increase in income of four billion dollars each month. The cartel, finding themselves with more money than they could possibly spend, turned paper into gold, causing the price of gold to run up, creating a self-defeating investment.

The price of gold then fell from $800, since they didn't drop the price of oil, what did they do with the surplus cash? My friend explained they believed in the old saying "money in the bank was safe". So they put the 'money in the bank' in every major bank in the Western world. Now, the cartel was as unknowledgeable as ordinary citizens about banking and they did not realize that bankers only want new funds as long as they have an expectation of being able to reloan these funds again and collecting interest on those loans as it's profit. Funds on deposit in a bank are listed as debits, while funds on loan are listed as assets. So, in order to appear not to be in desperate shape the banks must reloan those "cartel-dollars".

I remarked to my friend that the banks now had the "hot-money". It appears that the cartel had passed 'more money than they could spend' to the banks who now had 'more money than they could lend'. That's exactly right, he said, the banks had to find borrowers for the tens of billions of dollars each month that were deposited by the cartel. They became desperate to lend money to anyone, even uncreditworthy Marxist countries and Third World countries, who eagerly snapped the attractively rated loans. The Marxist governments who have never managed to produce enough to sustain themselves could now control their people with borrowed capitalist paper money. Furthermore, countries with no airports, since their citizens couldn't afford air travel, bought airlines and built expensive terminals. They also established urban renewal projects and make-work projects in cities that drew millions of people from the agricultural countryside, into the quickly overwhelmed cities, consequently creating greater slums. This caused an unemployment drain on the country's resources as former producers were now non-producers, but still consumers.

Then in late 1978, OPEC exacerbated the problem by tripling the price of oil. They couldn't leave well enough alone, they got greedier and tripled the problem. Third World countries depended on agriculture which relied on fertilizer to sustain the food production necessary to stave off starvation, but a lot of fertilizer is made from oil.

To purchase fertilizer to grow the crops, fuel to run the tractors and trucks to plant, harvest and transport the crops, these countries had to apply for more loans. The banks were afraid not to take the additional cash for they would have to explain their previous imprudent actions, so they took the tripled OPEC price increase in their tills and acted as though they were only to willing to help solve the problem. They all ignored the basics of unbacked printed debt and "Natures Law, of what goes around comes around" for the day of reckoning came in 1982, when Poland and her creditors awoke to the fact that Poland's exports would be less than the interest due on its $30 Billion debt. Then the Fed's paper house of phoney money started to blow slowly in the wind. First Zaire then Libya, and like dominoes; Argentina, Brazil, Mexico, Hungary, Yugoslavia, Romania, Bangladesh, Zambia, Sudan and Malawi began to throw their hands up and say that they can't repay the loans and would like more loans. By then the total owed by Third World countries to Western banks and governments, at the end of 1983, was over $750 Billion. According to the Fed's figures, the nine largest U.S. banks have loaned the Eastern Bloc and Third World countries an amount equal to over 225% of their combined capital. That means that if only ½ the amount of the loans default, those banks will be broke and bankrupt.

Date	Amount of Foreign Debt Monetized by the Fed. Res	Date	Amount of Foreign Debt Monetized by the Fed. Bank
April 21, 1981	$11.6 million	Dec. 21, 1981	$104.0 million
April 24, 1981	$38.4 million	Dec. 22, 1981	$71.0 million
April 28, 1981	$17.1 million	Dec. 23, 1981	$106.0 million
May 5, 1981	$18.0 million	Dec. 24, 1981	$102.0 million
May 7, 1981	$36.6 million	Dec. 28, 1981	$121.0 million
May 12, 1981	$18.0 million	Dec. 29, 1981	$73.0 million
May 13, 1981	$96.7 million	Dec. 30, 1981	$22.0 million
May 27, 1981	$ 9.3 million	Jan. 6, 1982	$88.0 million
June 9, 1981	$44.8 million	Jan. 13, 1982	$31.0 million
June 10, 1981	$108.0 million	Jan. 19, 1982	$ 8.0 million
June 23, 1981	$ 1.0 million	March 4, 1982	$125.0 million
June 30, 1981	$27.0 million	Mar. 5. 1982	$86.0 million
July 1, 1981	$18.1 million	Mar. 8, 1982	$ 9.0 million
July 10, 1981	$48.8 million	Mar. 8, 1982	$188.0 million
July 13, 1981	$49.0 million	Mar. 9, 1982	$77.0 million
July 14, 1981	$76.4 million	Mar. 9, 1982	$216.0 million
Oct. 5, 1981	$ 8.0 million	Mar. 10, 1982	$90.0 million
Oct. 6, 1981	$106.0 million	Mar. 10, 1982	$235.0 million
Oct. 7, 1981	$ 7.0 million	Mar. 31, 1982	$64.0 million
Oct. 7, 1981	$196.0 million	April 6, 1982	$246.0 million
Nov. 17, 1981	$51.0 million	April 6, 1982	$72.0 million
Nov. 18, 1981	$45.0 million	April 7, 1982	$93.0 million
Nov. 24, 1981	$20.0 million	April 7, 1982	$239.0 million
Nov. 27, 1981	$31.0 million	April 7, 1982	$183.0 million
Nov. 30, 1981	$57.0 million	April 12, 1982	$31.0 million
Dec. 1, 1981	$82.0 million	April 13, 1982	$25.0 million
Dec. 2, 1981	$64.0 million	April 13, 1982	$42.0 million
Dec. 3, 1981	$28.0 million	April 14, 1982	$27.0 million
Dec. 4, 1981	$36.0 million	April 14, 1982	$ 1.0 million
Dec. 7, 1981	$31.0 million	April 15, 1982	$51.0 million
Dec. 8, 1981	$ 5.0 million	June 30,1982	$39.0 million
Dec. 9, 1981	$55.0 million	July 6, 1982	$43.0 million
Dec. 15, 1981	$ 8.0 million	July 7, 1982	$81.0 million
Dec. 16, 1981	$45.0 million	July 7, 1982	$27.0 million
Dec. 18, 1981	$15.0 million	July 8, 1982	$ 7.0 million

I exclaimed "How did they manage the cover-up?" My friend went on to describe the deception. He stated, "to avoid showing the loans on which no interest is paid (forget payment of principle) as bad loans, the banks and government officials are calling them, "non-performing loans" which is a gross understatement (more word-speak). The greatest illusion of insolvency is called "rescheduling", this is where the banks make a loan to themselves or another bank to pay themselves the interest due. This, a slight-of-paper trick, is called "rolling over".

My friend further explained that when you lend money to someone who has the ability to pay you back, you are called the lender, and they are called the borrower. When you lend someone more money than they have the ability to repay and they default - you are called partner, or loser. The media keeps saying that the "debt cartel countries" are in trouble. The media is wrong - the banks and their depositors are in trouble, the debtors have spent the banks and their depositors money and there is nothing they can do but find another sucker to bail the banks out - enter the U.S. taxpayer, HELLO PARTNER!.

I asked "What makes you think the taxpayer won't be angry and object"? He answered, "the average person thinks 'so what'; the bad loans will be called uncollectable and written off, causing the banks to close, they believe "they will reopen - business as usual". But, the average person knows very little about bankers, they (the bankers) are not fools, they saw this problem coming years ago, that's why they took the additional money. It gave the banks and politicians time so they could push for the passage of Public Law 96-221, known as "The Monetary Control Act of 1980".

Very few of the 380 lawmakers who voted for the bill, ever read the bill. They knew the bill was strongly backed by the Carter administration and the Federal Reserve Board. This bill had been described to Congress as a "Technical Banking Bill" which would phase out Regulation Q, and gradually raise interest rates payable to small savers." To the non-reader it sounded good, but buried in the bill are astonishing provisions giving the Federal Reserve Board enormous powers. Naturally the Fed promised the Congress, they would never use these powerful provisions. I then asked my friend, "if they were not going to use these powers, why then did they feel the need of these powers?" He answered, "They lied".

He further explained, Section 105(2) "...changes what constitutes a legal reserve for the banking system, so that effective June 1, 1981 the Open Market Committee of the Federal Reserve became able to expand the money supply by purchasing...(c) All obligations of foreign governments or their agencies; (D) Obligations of foreign banks if they are guaranteed by that bank's government." Since passage of this "Control Act" the Federal Reserve has only used this "ACT" 136 times to the tune of $3.3 billion.

My friend showed me the following data which was supplied by Congressman Ron Paul (R-Texas),

"Until last fall, information about the Fed's action under section 105(b)(2) of the Monetary Control Act was readily available to me and my staff. We obtained the data, such as the amount of foreign debt owned by the Fed, the countries which owed the debt, the number of times the Fed had used the debt as collateral for issuing Federal Reserve notes, the Federal Reserve Bank form which such notes were issued, and the amount of notes collateralized, by telephone. But last September our ready access was ended."

See the attached list of the dates an amounts of the Federal Reserve's actions, under the powers granted it by the Monetary Control Act of 1980, to monetize the debt of foreign governments and their agencies by issuing Federal Reserve notes to be collateralized by foreign government obligations. Most of these notes were issued by the Fed bank in Boston.

My friend further informed me that, the "Control Act of 1980" contains many other dangerous provisions, such as Section 105(6)(b) which eliminates the need for collateral for Fed Res notes held in the regional Fed banks. At the same time, it removes any restriction on the level of inflation such a move could cause. Section 103(2)(d)(3) allows the Fed to lower the reserve requirements of banks to zero, thereby ending the "fractional reserve system". The banks were required to keep between 10% to 15% in reserve. Replaced it with a "zero reserve" system, which is highly inflationary, and reloaning the same money seven times was very profitable to the banks under a fractional system. The "zero reserve" will make reloaning limitless. The profit potentials for banks is the same as the inflation potential to the public, it will be staggering.

I asked "didn't the Congress put any restrictions on the Fed"? My friend replied, "the law limits the zero reserve requirement to 180 days, unless the Fed votes to extend it another 180 days with no provisions limiting the number of extentions the Fed may make". Included in Section 103(2)(6)(1) is the provision permitting bank holidays to be declared "...in the event of a natural calamity, riot, insurrection, war or other emergency...on a state by state basis or region by region basis at the discretion of the Comptroller of the Currency, a State, or designated State official." I asked, "who is going to celebrate this holiday and wouldn't declaring a bank 'holiday' (more word-speak) cause a calamity, riots, insurrection, war or other emergency? My friend replied that the banks and politicians with great foresight on their part had a House Congressional Resolution 290 passed. The House and Senate in March 1982 passed this provision which pledges the "...full faith and credit of the U.S. government" to cover all insured deposits in all institutions covered by the F.D.I.C. and the F.S.L.I.C.

I asked, "isn't this like giving a drunken sailor a blank check"? My friend informed me the bankers were still not finished, they pushed their friends in Congress [Mr. St. Germain and Mr. Garn] to pass the "Omnibus Banking Bill", which passed by a voice vote - no record kept at 10:30 on October 1, 1982. The provisions of this bill; "...to make deposits in, assume the liabilities of, buy the assets of, or make contributions to any insured institution at the sole discretion of the insuring agencies, and upon such terms and conditions as they decree." My friend remarked, "one guess where the FDIC and FSLIC are going to get the money?" The banks WILL be bailed out, even if we have to bankrupt the country to do it.

I started to ask him another question, "What's a person to do? He said if I agreed to pay him for financial advice he would be glad to consult with me, he stated "Every one is going to suffer in proportion to their apathy". He did say "Don't re-elect anyone"! "For you'll only get more of what they gave you the first time". He also agreed to have lunch with me again and soon. Until next time, remember, there's no such thing as a free lunch.

For additional information call Bob Graham - (215) 355 - 5660 Investment Advisor
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Box 1776
Richboro, Pa., 18954

What would happen if the U.S. government and the banks failed ? *9/1/84*

Exhibit #5

While at lunch with my friend the other day, I asked him to explain why everyone is expecting a " Bank crisis" because of the default of Foreign debt. I'm still confused about the last lunch, when he explained how the U.S. government regulations and laws would affect me, and cause me to bail out the banks as a U.S. taxpayer.

He asked me if I had every played the game "Monopoly". I think everyone has, but he said, what would happen if the bank were allowed to be a player? Suppose the banker were allowed to buy properties and build hotels and houses on its properties. I replied, that because the banker controlled the money - unlimited amounts - the bank could not lose. All the other players would eventually be forced to sell their properties and they would be out of the game. My friend then stated "When all the players quit the game - even the winner's game is over. So in order for the game to continue and the banker to enjoy his victory he must let the other players appear to have a chance to win".

My friend then reminded me of "The Monetary Control Act of 1980" which allows the banks and the Federal Reserve to purchase almost anything they wish, houses, stock, commodities, bank note, foreign debts, etc. - all with created money, the Federal Reserve has never been audited by an outside auditor. He believes the so-called 'bank crisis' is a smokescreen designed to cover-up the end of the game. For if the banks appear to have lost assets because of their bad loans and the lender of last resort is the U.S. taxpayer who will have to bail out these phony loans with taxpayer future production then their game can continue. But if the taxpayer quits their game, then the banker's phoney game has ended, because there are no more players that can be duped.

I asked "How could we operate a society without banks and the Federal Reserve? He stated, that for 137 years the United States didn't have either and this country was the greatest economic power in the world. But since December of 1913, the creation date of the "Twin Evils" (the 16th Amendment and the Federal Reserve), (Isn't it funny they were both made law at the same time?). Since the inception of the "twin evils", the United States has experienced 2 world wars, many depressions, wild inflation, and corrupt government at almost every level. My friend said "You can't have honest government with dishonest money".

The Monetary Control Act of 1980 is misleading, since it removes all controls from the Federal Reserve, which is neither Federal nor has any known reserves. This private bank is now allowed to create "paper money" without any reserves. The beauty of this fraud upon the unknowing citizens of the U.S. is that the banks may lend money (bank asset) without corresponding liability (depositors' deposits). Supposed you could lend twenty people $100, now suppose only 10 pay you back, what did you lose? Answer: you made $1,000, because you didn't put any money up to begin with. Now, suppose you really got greedy and you could make the U.S. taxpayers pay you the other $1,000 you claim you lost, you would really have it made. And the "bankers game" could continue.

*But, what would happen if the banks closed and the U.S. government failed? **NOTHING!** Absolutely nothing for the productive citizens of the United States. For if the original instructions [THE CONSTITUTION] would be re-read and re-instituted and "We The People" once again would have Constitutional RIGHTS this would restore us to a "Republic", the original form of government our forefathers gave us.*

9/1/84

The same thing is almost true about taxes, for the government only took in taxes onehalf (½) of what they spent in 1983. They just printed the difference. Because the Fed has the ability to print "paper money" they can control every market which has the ability to "sell short". This manipulation by phony paper will delude the average citizen and cause him to not want any change. The government has only one product to sell and that product is **"fear"**.

My friend insists that the Communists can't even feed themselves and if the U.S. government didn't give them feed and grain at a preferred rate, which is subsidized by the U.S. citizen through his paying of higher prices and more taxes. The Americans could enjoy a higher standard of living without this Communist "food package". Communism is good for the U.S. government for the government can use the "commies" as bogeymen. In fact if there were no communists, the U.S. government would have to invent them. Consider this: Why would we need all the military and where would all the defense jobs disappear to if we didn't have the "fear" of war. And of course, why would we need such a large defense department and total defense budget, and long winded politicians to talk about either a greater or lesser amounts without the "fear" of war.

The same is true with "food stamps", it's government's way to make unkowledgeable people dependent upon government by "fear" of starvation, with the only means of survival being government. Government forgets to tell its citizens that if there were no food stamps the price of food would go down. The same "fear" tactic is used to continue food control by "not planting subsidy - soil banking". This paying for not planting only increases the money supply and the deficit.

Now the government's "fear" machine is scaring the U.S. citizen with a "bank crisis". They say that's the reason for high interest. But, no one knows how much money really is in circulation, no one ever tells you "where the money goes, when the money supply drops"? What happens to the loans that are never repaid? They are called repositioned loans and the interest which is not paid is carried on the books as an "asset".

Well I asked, "if every product can be controlled is there any way a citizen can win? Yes, my friend answered, it is in products which cannot be sold short, that is portable, that is extremely private, that is rare, and that is limited in supply. He told me a couple of these investments. He also warned, if government has its way, nothing will be sacred and you will really get to know what "fear" is. He suggested another lunch at which time he would tell me some of the "secret" moves to make.

His closing remarks were "How can 5,000 IRS agents and 50,000 politicians ever control 90 Million taxpayers unless they want to be controlled?" I don't know the answer; do you? Hope to see you at lunch soon, I said, as I paid the bill. Remembering, there is no such thing as a free lunch, everything has a cost and the price of freedom is less than the cost of slavery.

Bob Graham
Investment Advisor

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McNEIL

McNEIL CONSUMER PRODUCTS COMPANY

TO ALL EMPLOYEES

DATE August 24, 1984

FROM J. Kreiensieck/V. Klingler

COPIES

SUBJECT TUITION REIMBURSEMENT PROGRAM

In our June 6, 1984 memo, we advised all employees of a change in the federal tax laws earlier this year which required an employer to treat tuition reimbursement as taxable income to employees. We noted that legislation was pending in Congress that would override this change and continue to "exempt" such reimbursements from compensation treatment for at least the next two years.

Unfortunately, this legislation did not pass Congress. Therefore, we must now begin to treat as taxable income any tuition reimbursement paid to employees for courses taken after January 1, 1984. The amount of the reimbursement will be added to employees' W-2 earnings and the appropriate taxes withheld. Within the next two weeks, the Treasury Services Department will distribute a separate memo to all affected employees describing the procedures and timetable for the withholding.

We regret the need to make these changes and hope they do not place an undue burden on those affected. We feel the company's Tuition Reimbursement Program still provides an excellent opportunity and inducement for interested employees to pursue outside educational opportunities. If you have any questions on this matter, please call Personnel's Nancy Buchert (ext. 7304) or Treasury Services' Ginny Klingler (ext. 7455).

Jack Kreiensieck
J. Kreiensieck

Virginia Klingler
V. Klingler

/nba
3625P

IN THE UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

UNITED STATES OF AMERICA : NOS. 83-1797
: NOS. 83-1932
-V- : NOS. 83-1933
: NOS. 83-1934
ROBERT B. GRAHAM SR., et al. : Cr. NOS. 83-140 and 217

APPELLANT GRAHAM'S REQUEST FOR ORAL ARGUMENT AND OPINION OF COUNSEL AS TO REASONS WHY ORAL ARGUMENT SHOULD BE HEARD PURSUANT TO USCA RULE 12(6)

COMES NOW the appellant Graham by and through his counsel. Ronald Brent Boutwell, and requests that the above entitled matter be set for oral argument on the following grounds:

1. Appellant's appeal is not frivolous. The lower court rejected the prosecutors position that the appeal was frivolous (G. 262a, lines 7-13).

2. The facts and legal arguments are not adequetly presented in the briefs and record. More specifically:

a. The integrity and honesty of the government has been challenged because of alleged perjurious conduct of a government witness during the trial. This matter is discussed in Appellant's brief under point V (pages 36, 37, and 38). The government has apparently refused again to even address this issue. The government's silence in the face of such accusations is too deafening to ignore. When this matter was first raised in the lower court following the trial, by appropriate request and motion, the government refused to respond unless the court required a response. The lower court ruled in the government's favor without comment. See Appellant's brief for details.

STATEMENT OF FORTESCUE W. HOPKINS, PRESIDENT, TAXATION WITHOUT DISCRIMINATION, NEW CASTLE, VA

Senator **Chafee**. Mr. Hopkins.

Mr. **Hopkins**. Mr. Chairman, I am from Virginia. I have been a tax attorney for 36 years. I went to work as an attorney for the Internal Revenue Service in 1948 in Chicago. So I have been learning the 1939 code and every code ever since then. The 1984 at, which is a couple of inches thick, I'm trying to understand.

I represent Taxation Without Discrimination, which is a Virginia nonprofit corporation. The tax revolution in this country is not coming. It is here and now. There is only one possible course of action which will defuse this revolution. Find the root cause and get rid of it. That's what my tax Magna Charta does. It eliminates the power of Congress to enact discriminatory income tax laws designed to achieve nonrevenue related objectives.

No Bradley-Gephardt, Kemp-Kasten or other similar Band-Aid amendments to the Internal Revenue Code will stop this revolution. Kemp-Kasten is a step in the right direction by recognizing that Social Security taxes, are, in fact, income taxes.

Congress is always sitting as a constitutional convention. Two-thirds of each House can quickly approve and propose my tax Magna Charta as a constitutional amendment. Given the opportunity to do so, I believe that only a handful would vote against it. Assuming my advice is rejected, what then is the alternative?

The tax revolution will continue and it will ultimately compel the State legislatures to call an open constitutional convention. At this convention, the tax Magna Charta will be approved. However, it is extremely doubtful that the open convention would stop at merely cleaning up the tax mess. They might carefully examine all of the unwarranted and self-delegated powers of this Congress in order to make ours a more representative form of Democracy.

They might carefully examine the rules of this Congress, require a monthly rotation of chairmanship of committees, and provide committee assignments on a totally nonpolitical basis. Other proposals might include a single 5 year term for all Congressmen, increasing the number of Senators from each State to reflect population or getting rid of the Senate entirely. A line-item veto power for the President would be proposed. There would be certain conditions underwhich legislation would be subject to supreme court review or national referendum before going into effect.

Priority would be given to the elimination of all retirement benefits for Congress. In accordance with Patrick Henry's objections, they would certainly remove from Congress the power to set its own pay and other tax free perquisites. Becoming a member of Congress would then become an honor and not a career.

Finally, it is certain that an open convention would propose amendments to article 5 of the Constitution to make the amendment process more viable, which might include a nationwide referendum.

The list of possibilities goes on and on. Gentlemen, the choice is yours. Give up now the power to enact discriminatory tax laws to achieve nonrevenue related objectives, a power that you are, clearly, not entitled to possess, or, later, be forced to concede far greater powers.

After this hearing, taxation without discrimination is not going to mess around. It plans a worldwide crusade for all countries to adopt revenue laws that are nondiscriminatory and do not attempt to achieve nonrevenue related objectives, conditions which are essential to individual political responsibility and individual economic opportunity

Thank you.

Senator CHAFEE. Thank you very much.

[The prepared written statement of Mr. Hopkins and Mr. Ellison follows:]

TAXATION WITHOUT DISCRIMINATION (TWD)

SR 1, Box 23-A, New Castle, Va. 24127, 703-864-5949
Statement of Fortescue W. Hopkins
Before the
Senate Committee on Finance
Hearings on Major Tax Reform Options
September 20, 1984

Mr. Chairman:

I am honored to have this opportunity to present TWD's Tax Magna Carta, a proposed Constitutional Amendment which I respectfully request that your Committee approve and submit to both houses of Congress for their consideration and approval:

THE TAX MAGNA CARTA
CONSTITUTIONAL AMENDMENT

IN SECURING THE REVENUE OF THE UNITED STATES OR OF ANY STATE, DISTRICT, TERRITORY OR POLITICAL SUBDIVISION THEREOF, NO LAW, REGULATION OR PROCEDURE WITH RESPECT TO ANY INDIVIDUAL CITIZEN OR EQUITY OR NON EQUITY ENTITY OR ORGANIZATION DOMICILED IN THE UNITED STATES, SHALL BE IN THE SLIGHTEST DEGREE EITHER DISCRIMINATORY OR INTENDED TO ACHIEVE A NON REVENUE RELATED OBJECTIVE; PROVIDED, HOWEVER, THAT, WITH RESPECT TO ANY INCOME TAX: (1) INCOME OR LOSS OF AN EQUITY TYPE ORGANIZATION (STOCK CORPORATION, PARTNERSHIP, ETC) SHALL BE DEEMED PASSED THROUGH TO ITS EQUITY HOLDERS; (2) RELIGIOUS ORGANIZATIONS, ESTATES AND TRUSTS (TO THE EXTENT OF INCOME NOT DISTRIBUTABLE TO BENEFICIARIES), ASSOCIATIONS AND NON-STOCK, NON-EQUITY, ENTITIES OF ANY KIND SHALL BE TAXED AS AN INDIVIDUAL CITIZEN; (3) THAT ONLY "NET INCOME" WILL BE TAXED, WHICH IS DEFINED AS THE RECEIPT OF ANYTHING OF VALUE LESS COST OR DIRECTLY RELATED EXPENSES IN THE PRODUCTION OF VALUE, AND (4) THAT "DIRECTLY RELATED EXPENSES" SHALL BE DEEMED TO INCLUDE THE VALUE OF GIFTS TO RELIGIOUS ORGANIZATIONS AND ALL COSTS RELATED TO THEIR RELIGIOUS ACTIVITIES.

ARGUMENT IN SUPPORT OF THE TAX MAGNA CARTA

HISTORY

It has been said that "those who forget history are forever condemned to repeat it". The first recorded discriminatory income tax was imposed during the Archonship of Nausinicus (Athens, B.C. 380). Other discriminatory taxes (exemptions and progressive rate taxes) were: The French *Cinquantieme* of 1295, the English graduated poll tax of 1379 and graduated income tax of 1435, the German *Reichsabchied* of 1512, the *Catasto* of Firenze (1427).

The Medici, of course, eagerly seized upon this democratic reasoning and converted the graduated tax into an engine for ruining their wealthy rivals. The history of the Florentine *Decima Scalata* (1480) has been made use of as a warning of the evils of progressive rate taxation. The list goes on and on. Very few countries have failed to impose discriminatory income taxes. In Florence and in France, the evils and abuse of discriminatory taxation ultimately led to revolution. After the Revolution in France all income taxes were abolished.

Is it to be supposed that our patriots who framed our Constitution in 1787 and 1788 were not the most educated and talented group of people ever assembled? Is it to be inferred that they were not familiar with the evils of discriminatory taxation as demonstrated by the examples of history? Is it to be supposed that the principal reasons for the American Revolution (the discriminatory taxes imposed by Great Britain-the Stamp Act, the Tea Act, Navigation Acts and other inflamatory imposts)were so quickly forgotten by the Framers?

Not so, the Framers of our Constitution thought they had forever prohibited discriminatory taxation by requiring direct taxes to be *apportioned* and indirect taxes to be *uniform*. They intended "uniform" to mean "uniform and equal" (non-discriminatory) and by failing to more precisely define their understanding of the meaning of "uniform" they failed to anticipate the "slipperiness of the eels of the law" (Jefferson's observation of the Supreme Court). They also failed to precisely define "direct" and "indirect taxes" again giving the eels of the law the opportunity to redefine "indirect taxation" to their own "Communistic" predilections. The second plank of the Communist Manifesto advocates progressive rate taxation.

Except for a brief period during the Civil War, there were no discriminatory taxes imposed by the United States until 1895. Thus for a period of over 100 years our Legislators and Courts alike, thought that "uniform" meant "uniform, equal and non-discriminatory".

In 1895, Congress imposed a 2% flat income tax with a $4,000 exclusion and other exemptions. In its seminal decision that this tax was unconstitutional the Supreme Court in *Pollock v Farmers Loan & Trust Co*(1895), came up with three important conclusions;

1. An income tax on rents and royalties was a "direct tax" and had to be apportioned.

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2. A tax on income from State and Municipal obligations was unconstitutional.

3. The income tax with respect to other income was an excise(an indirect tax).

4. The $4000 exemption was a discriminating feature and violated the intent of the Framers of the Constitution to provide against discriminatory taxation and was not within the intended meaning of the term "uniform".

The reasoning of Justice Field in the Pollock case bears repeating:

> "The income tax law under consideration is marked by discriminating features which affect the whole law. It discriminates between those who receive an income of $4000 and those who do not. It thus vitiates in my judgment, by this arbitrary discrimination, the whole legislation."
>
> * * *
>
> "Whenever a distinction is made in the burdens a law imposes or in the benefits it confers on any citizens by reason of their birth, or wealth, or religion, it is class legislation, and leads inevitably to oppression and abuses, and to general unrest and disturbance in society."
>
> * * *
>
> "Under wise and constitutional legislation, every citizen should contribute his proportion, however small the sum, to the support of the government, and it is no kindness to urge any of our citizens to escape from that obligation. If he contributes the smallest mite of his earnings to that purpose, he will have a greater regard for the government and more self-respect for himself, feeling that, though he is poor in fact,he is not a pauper of his government. And it is to be hoped that, whatever woes and embarrassments may betide our people, they may never lose their manliness and self-respect. Those qualities preserved, they will ultimately triumph over all reverses of fortune."

If the foregoing statement means anything, it suggests that a self assessing tax system cannot be sustained without self respect and individual political responsibility. Justice Field closed his opinion with the following:

> "Here I close my opinion. I could not say less in view of questions of such gravity that go down to the very foundation of the government. If the provisions of the constitution can be set aside by an act of congress, where is the course of usurpation to end? The present assault upon capital is but the beginning. It will be but the stepping-stone to others, larger and more sweeping, till our political contests will become a war of the poor against the rich-a war constantly growing in intensity and bitterness. "If the court sanctions the power of discrimination taxation, and nullifies the uniformity mandate of the constitution"as said by one who has been all his life a student of our institutions"it will mark the hour when the sure decadence of our present givernment will commence." If the purely arbitrary limitation of four

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> thousand dollars in the present law can be sustained, none having less than that amount of income being assessed or taxed for the support of the government, the limitation of future congresses may be fixed at a much larger sum, at five or ten or twenty thousand dollars, parties possessing an income of that amount alone being bound to bear the burdens of government; or the limitation may be designated at such an amount as a board of "walking delegates" may deem necessary. There is no safety in allowing the limitation to be adjusted except in strict compliance with the mandates of the constitution, which require its taxation, if imposed by direct taxes, to be apportioned among the states according to their representation, and, if imposed by indirect taxes, to be uniform in operation and, so far as practicable, in proportion to their property, equal upon all citizens."

Five years later in 1900, the Supreme Court considered a Federal Legacy (Estate) tax in the case of *Knowlton V Moore* (178 U.S. 41). The Court held that the tax was laid upon the right of transmitting property from the dead to the living; and the fact that this privelege was granted by the State did not deprive the United States of the right to impose the tax. The purpose of this "fiction" was to enable the Supreme Court to classify what by any definition was a direct tax as an indirect tax and subject to rule of "uniformity throughout the United States". Apparently, it was deemed that getting around the uniformity requirement would be less difficult than obscuring the apportionment requirement of a direct tax.

Justice White, in his opinion in the *Knowlton* case held that the uniformity requirement of an indirect tax was only "geographical" in its character and did not require intrinsic uniformity (equal & non-discriminatory).

In the *Pollock* case this contention was specificully rejected: "A law containing arbitrary exceptions can in no just sense be termed uniform".

Following the 1895 decision in *Pollock* the personnel of the Supreme Court was substantially changed by 1900. Chief Justice White (who dissented in the *Pollock* case) took the opportunity in the *Knowlton* case to convince a majority of his brethern to reverse Justice Field's views that "uniformity" meant equal and non discriminatory and, in so doing, justified it with the following rationale:

> "The review which we have made exhibits the fact that taxes imposed with reference to the ability of the person upon whom the burden in placed to bear the same have been levied from the foundation of the givernment. So, also, some authoritative thinkers, and a number of economic writers, contend that a progressive tax is more just and equal than a proportional one. In the absence of constitutional limitation, the question whether it is or is not is ligislative and not judicial. The grave consequences which it is asserted must arise in the future if the right to levy a progressive tax be recognized involves in its ultimate aspect the mere assertion that free and representative government is a failure, and that the grossest abuses of power are foreshadowed unless the courts usurp a purely legislative function. If a case should ever arise, where

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> an arbitrary and confiscatory exaction is imposed bearing the guise of a progressive or any other form of tax, it will be time enough to consider whether the judicial power can afford a remedy by applying inherent and fundamental principles for the protection of the individual, even though there be no express authority in the Constitution to do so. That the law which we have construed affords no ground for the contention that the tax imposed is arbitrary and confiscatory is obvious."

Justice Whites assumption that a free and representative government can safely handle discriminatory taxes without the grossest abuses of power has now been tested by 84 years of experience. If this is true what then is the purpose of these Tax Reform Options Hearings? I cannot help but speculate that Justice White being from Louisiana was schooled in the Napoleonic Code and not the English common law because it is difficult to believe that any Justice schooled in the legal history of the English common law would ever have made such a statement giving to what was supposed to be a government of limited powers such unlimited power.

The reality, however, is that there is no case in history of a Free and Representative Government being given the unlimited power of discriminating taxation that did not indulge in the grossest abuses of that power. For example, the retroactive reversal of the Supreme Courts Diedrick decision in DRA-84 for the sole benefit of a group of wealthy people is an illustration of what I at least, consider to be the grossest possible abuse of this power.

Following in the footsteps of Knowlton, the Supreme Court held in Flint v. Stone Tracy (1907) that a corporate progressive rate income tax with exemptions was an indirect tax subject to the rule of geographic uniformity. No mention was made that they had, in effect, overruled their previous decision in Pollock that an income tax on rents & royalties was a "direct" tax.

Upon reviewing this decision Congress decided that it would like to impose an income tax. Congress was relatively certain, in view of the Flint & Knowlton cases that the Supreme Court would reverse its decision in Pollock and hold an income tax constitutional. However, it was afraid that the average American would lose respect for a Supreme Court making such a hasty flip-flop. Also, Congress wanted to reverse the Pollock holding that State & Municipal bonds were exempt from Federal taxes. Also, Congress wanted to remove the apportionment requirement in case any tax was held to be a direct tax. Accordingly the 16th Amendment was proposed by Congress and ratified by the States. This Amendment simply provided that Congress could levy a tax on "income from any source whatsoever without regard to apportionment".

There are some people in the United States who are under the impression that income taxes,discriminatory or otherwise are authorized by the 16th Amendment. However there is nothing in this Amendment that authorizes discriminatory income taxes. On the contrary, by permitting the taxation of tax exempts, this Amendment is totally consistent with the TAX MAGNA CARTA.

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The great irony of the 16th Amendment is that Congress has chosen to continue tax exempts and that the Supreme Court in Brushaber v. Union Pacific (1916) ignored the purpose of this Amendment by relying for its justification of income taxes as an indirect tax and as a discriminatory tax on its two previous cases of Flint & Knowlton.

Justice White in the Knowlton case said that the Supreme Court had not totally opened the Pandora's Box of discriminatory taxation and that if things got out of hand they would apply "inherent and fundamental principles for the protection of the individual. In the last few years there are no cases to my knowledge wherein the Supreme Court has held a section of the Internal Revenue Code unconstitutional.

Sadly, it is evident that the Supreme Court has failed to protect the rights of taxpayers from the grossest abuses of power. By its strict definition of "discrimination" in matters affecting race, religion, sex & civil rights, it has inundated itself with litigation. It obviously realizes that the slightest restriction of Congresses' abuse of the power to enact discriminatory tax laws would create a tidal wave of litigation. By permitting a discriminatory WPT, the present Supreme Court has given Congress the signal that they will countance the "grossest abuses of power" involving discriminatory taxes. In explaining this situation to the American people, TWD does not plan to obscure the role played by the Supreme Court. TWD will advise the American people not to waste time on Congressmen who it is presumed will not violate a Patrick Henry maxim: "Power once granted to a legislative assembly will never be voluntarily surrended", but to concentrate their efforts on the area where the only possible hope for relief from "the grossest abuses of power" exists, i.e. the Supreme Court and State Legislatures.

Finally, the only person who is in a position to fairly determine how a tax should discriminate does not live on this planet. The christian religion does not endorse progressive rates or exemptions. It does however endorse "tithes"(a proportional donation)

WHAT WILL THE TAX MAGNA CARTA (TWD) ACCOMPLISH?

1. TMC will reverse the error of the Supreme Court beginning in 1900.

2. TMC will give every American a sense of self-respect knowing that he has contributed his fair share to the operation of government.

3. With this self-respect, the lack of discrimination and the one page tax return for both State & Federal taxes, a self-assessing tax system will once again become totally practical.

4. TMC will eliminate Social Security (FICA) taxes but not the benefits - the flat tax rate will have to be high enough to cover these benefits. The regressive Social Security tax constitutes one of the grossest examples of discrimination against the youth, workers,minorities & small businessmen.

5. TMC permits taxation of all religious organizations but does allow an unlimited deduction for gifts to religious organizations. It is the grossest form of discrimination to require governments to render free services to religious organizations. Religious organizations will

be required to file tax returns, pay tax but they will be permitted a deduction for all expenses directly related to their religious activities.

6. TMC eliminates gift and inheritance taxes as such but does tax gifts and inheritances as income to the donee (including religious organizations).

7. To produce the present revenue, the flat rate under TMC is estimated to be not in excess of 10%. The taxable base of TMC by including gifts & inheritances, etc is greater than the GNP. There is no tax exempt income, loopholes, exemptions, credits, etc. All PACS & so called tax exempt (and strictly religious) organizations would be taxed.

8. TMC is a proposed Constitutional Amendment with lastingeffect and not a statute (reversible before it goes into effect).

9. TMC does not tell Congress what it can do. It does tell the Supreme Court what Congress cannot do and it does reverse certain prior erroneous Supreme Court decisions.

10. TMC would, in effect, require a proportional income tax (a flat tax) on net income but TMC imposes no restriction on a rate.

11. TMC would eliminate all presently so call "tax expenditures" including homeowners interest. If Congress wants to subsidize homeowners and such a subsidy is not permitted by our Constitution, why should they be permitted to do "indirectly" what would be "unconstitutional" if done "directly"?

12. Under TMC there would be no exclusions, (however small), no exemptions, no credits, no non-business deductions.

13. Under TMC, the tax would be on net income but there would be no discrimination or distinctions in determing net income and no non-revenue related objectives could be sought.

14. TMC would affect not only Federal revenue laws but all State & local revenue laws. It would make all state, local & Federal income tax laws totally parallel so that one return could cover them all.

15. TMC would tax all insurance receipts, pension or profit sharing, Social Security benefits, anything of value, less first a return of capital or investment.

16. TMC would permit no distinction between "capital gain" and "ordinary income". No income would be "tax-exempt".

17. TMC would, in effect, require a greater distribution of corporate dividends to cover taxes of shareholders and since there would be no taxes at the corporate level, the expense of excessive management compensation would not have the tax saving component it does today with the result that shareholders participation and democracy in large companies would be strengthened.

TWD

CONCLUSION

A. In its blatant abuse of its power to enact discriminatory tax laws for non-revenue related objectives Congress is tampering with the very soul of America. The American people may not yet fully appreciate the danger of deficits but their rage against the proliferation of discriminatory tax laws is here and now and growing at a rate the average Congressman cannot even begin to imagine. Congress has by its ever increasing creschendo of abuses lit the fuse and when the explosion is over, the power of Congress to enact discriminatory tax laws (and to feather their own nests) may be severely curtailed. Also, they may find their rules rewritten to provide a more representative form of democracy.

B. TMC will reawaken individual political responsibility. The principal beneficiaries of TMC would be be the youth, blacks, ethnic minorities and workers. TMC would reduce their overall tax rates. It would give them what, in reality, they do not now possess: "individual economic opportunity" (IEO). They could have employees, start any business no matter how small without the present choking bureacratic red tape and the need for a lawyer & accountant. There would be no withholding & no unemployment tax. Above all, however, they would be freed from the most vicious of all taxes, which bears most heavily upon them - the regressive Social Security tax. There would be no need, as now, to be forever locked in as "second class citizens" working for big corporations or big government.

C. If, in fact, excessive power created by excessive wealth is a social evil and not merely an excuse for the elite new class (ENC) to maintain its power and prerogatives, this can be cured, at death, by state law, not by taxes, by requiring substantial devolution among heirs, as suggested by Thomas Jefferson(i.e.forced heirship laws of Louisiana). Congress, however, has now proved to the satisfaction of the American people, that the unlimited power to enact discriminatory taxes is not the way to achieve this objective.

D. The appeal of TMC is irresistable. It can be seen and easily understood by the great mass of Americans. There is no other choice, the abyss of statism is at hand. The present tax system represents the brink of this abyss. We will see if the American people have the sense and courage of their ancestors to back off. As they begin to sense the clear danger of this abyss and start putting the blame where it belongs, not on Congress (for doing only what comes naturally - buying votes) but rather on the Supreme Court Justices (who should have a higher degree of responsibility), you may see the Justices come to their senses in time to save us from a Constitutional crisis of immense magnitude.

E. TMC holds the promise of being the most important step ever made in preserving personal liberty, promoting free enterprise & keeping our free society from becoming a totalitarian police state.

TAXATION WITHOUT DISCRIMINATION*

By Fortescue W. Hopkins

Fortescue W. Hopkins, President

* A Virginia non profit
non-stock corporation
incorporated July 2, 1984

TWD

MR. CHAIRMAN, My name is Edward A. Ellison, Jr. of Baltimore, Md, and I would like to thank this Committee that my request to testify on behalf of the American people, to provide input to this committee has been honored.

The subject of taxation, which is before this committee, is perhaps of no less importance today than it was over 200 years ago when oceans of blood were spilled by a people who freed themselves from many of the sufferings of which todays people complain.

Let us not forget in our discussion on taxation, the blood spilled during the Revolutionary War . . . for it was this sacrifice which today allows this public hearing on taxation to take place, and the will of the people to be heard by their elected representatives.

During the past several years I have travelled across the United States and have been fortunate enough to meet with citizens from almost every station in life. I have lectured on the topic of taxation before audiences composed of businessmen, manufacturers, farmers, individual entrepreneurs, and just plain ordinary folks who live by the sweat of their labor.

I was inspired to learn during my travels, that the people across our nation are not as divided in their views, when it comes to taxation, as portrayed by todays political pundits. The common thread which I am happy to report to this committee, which binds our nation's people, is one of honesty, for they have been quick to support with vigor, the honest system of taxation which our founding fathers wrote into our Constitution - that is, after they have been educated to this system which has been curiously overlooked, or purposely ignored by ~~the peoples elected representatives.~~

The very fact that a special hearing on taxation is now in progress, and countless points of view have been stated before this committee by special interest groups seeking to extricate themselves from an obviously inequitable system of taxation, is evidence that a tax on earnings is not only patently oppressive, it is destructive to the general welfare of our nation.

During the first Congress of the United States, 1st Session, April 8th, 1789, Mr. James Madison, speaking before the House of Representatives which enacted our nation's first Revenue Raising Act, stated:

> ".....a national revenue must be obtained; but the system must be such a one, that while it secures the object of revenue it shall not be oppressive to our constituents. Happy it is for us that such a system is within our power, for I apprehend that both these objects may be obtained from an impost on articles imported into the United States."

Gentlemen, it is within this Committees power to promote a system of taxation which is not oppressive upon the people of the United States, nor any of the special interest groups in attendance at this hearing. All that is needed, is a desire to do so.

It is a commonly accepted fact that a tax upon the earnings of our nation's labor, manufacturers, agricultural industry and small businesses is a tax upon production. That, a tax upon production stifles a free exchange between labor and industry; impedes America's ability to produce; increases the price of our articles exported; which in turn is destructive to America's ability to compete in foreign trade, and thus, a tax based upon earnings is not only oppressive, it is not in the best interests of the United States.

To obtain a national revenue, from which to discharge the national debt, provide for our nation's common defense and fund those constitutionally authorized objectives which are enumerated in our Constitution, it is imperative that this committee take note of the 1st Congress of the United States which enacted our nation's first revenue raising act.

This Act opened with a stately preamble spirited by patriotism, responsibility, the love of freedom, and a sincere desire to bring prosperity to America through an America First Policy:

> "Whereas it is necessary for the support of government, for the discharge of the debts of the United States, and the encouragement and protection of manufacturers, that duties be laid on goods, wares, and merchandises, imported ..."

In agreement with the wisdom of our founding fathers and in the interests of the United States general welfare, it is essential that all federal revenue currently raised from the earnings of Americas labor, agricultural industry, manufacturers, and small businesses be suspended, and necessary revenue be raised from other sources, to wit:

(1) That articles of consumption, both domestic and imported, such as cigarettes, spiritous liquors, jewelry, (articles of consumption which are of a purely luxurious nature) ought to have an inland excise tax added to their consumption; taking into account the price of similar articles imported, and adjusting this tax on each specific article so both may

compete in our market on a fair and equal basis, while bearing in mind that an excessive tax upon such articles will reduce consumption and diminish a just source from which to fill the national treasure.

(2) Imported goods which are not of a purely luxurious nature, which can be, or are manufactured in America, ought to be taxed with a view to encourage and protect American manufacturers, while promoting fair trade, as opposed to free trade. The principles to be taken into consideration in the selection of those imported articles to be taxed, and the rate at which each imported article ought to be taxed are these:

(a) Imported articles which are produced by slave labor (produced in a labor situation in which the inalienable right of the individuals to contract out their own labor as they see fit being denied them without just cause) should be taxed in order to protect the standard of living enjoyed by Americans as predicted by the Framers and made possible by the obedience to our Constitution by our elected officials.

(b) Articles of consumption such as steel, aircraft, computers, vehicles used to facilitate internal and external commerce, tools of production, farm equipment, military provisions, etc., (all being necessary to the internal strength of our nation) ought to be taxed when imported, with a view to encourage and protect domestic manufacture of such articles.- ~~Imposts and duties upon imports in this~~

class are justified upon the principle of national security; that the United States must never become so dependent, or interdependent upon foreign manufactures as may weaken our internal manufacturing capabilities as would endanger our nation's general welfare if foreign trading partners should suddenly become hostile toward America, or intimidated by other hostile foreign powers.

(3) In addition to the above mentioned taxes on consumption, a tonnage tax upon the freight of foreign vessels importing articles of consumption is a proper method to: a) regulate trade with foreign nations; b) secure a national revenue; c) encourage the growth and protection of American owned carriers which are employed in foreign trade; d) protect American manufactures from unfair trade.

Vessels and aircraft employed in foreign trade being built in the United States, and belonging wholly to a citizen or citizens thereof, ought to be given a preference at our ports of entry. The principle upon which a tonnage tax upon the freight of foreign carriers ought to be imposed must take into account the nations with whom America trades; their policy on import taxation upon articles of consumption which America produces for export and any preference these foreign nations may give to carriers over our nations carriers at their ports of entry.

Applied properly, such a tax will provide a source from which to draw a national revenue; will greatly enhance a fair -

trade between American and foreign nations, particularly those nations exporting into our country virtually duty free, but are quite protective and discriminatory when it comes to accepting America's exports on an equal footing. This tonnage tax upon the freight of foreign imports will also provide a necessary mechanism to protect America's vital manufactures which is essential to America's internal strength.

(4) An internal tax, not mentioned above, and proper in its application is an excise tax upon domestic carriers when employed in interstate commerce, but, only justified in certain and limited cases: a) to insure safe passage of carriers as they pass from state to state (i.e. federal jurisdiction to prosecute and penalize hi-jackers, pirates, etc.,); b) inspection for contamination of food stuffs and raw agricultural produce; c) safety measures for hazardouw materials being shipped from state to state.

The principle justifying the above described tax is not one of raising revenue, but rather, only to raise necessary funds to pay for the cost of federal policing of interstate commerce as above mentioned. . . be it understood that each carrier is to bear its own just proportion as related to the cost of federal services rendered as applicable to the specific policing protection afforded. No other kind of federal tax upon interstate carriers can be justified, and as such, all other federal taxes which now increase the cost of interstate commerce and increase the cost of articles of consumption; are oppressive to production; damaging to United States competition in foreign trade, and ought to be immediately suspended.

Having expounded somewhat upon the method of raising a national revenue as adopted by our founding fathers, an America First policy, enacted during the First Congress of the United States, I would like to focus attention upon taxation as it applies to a balanced federal budget and the retirement of the national debt.

I have also furnished to members of this committee a bulletin which has been widely circulated by Lieutenent Colonel, U. S. Army retired Archibald E. Roberts. This bulletin contains a documented article titled "A SECOND CONSTITUTIONAL CONVENTION, WILL IT HAPPEN? ! " I have co-authored this article to expound upon the method by which our founding fathers agreed to pay off the debt of the Revolutionary War, and insure that a balanced budget would be maintained in the future by subsequent Congress' elected to manage the financial affairs of our national government.

In respect to a "Balanced Budget- Tax Limitation Constitutional Amendment," which is the title of Senate Report No. 97-151, 97th Congress 1st Session, pages 7,16,19 and on several other pages, it is acknowledged by the Senate Committee on the Judiciary that indeed, a requirement for a balanced budget exists in our Constitution! However, this Senate Report has failed to detail for the reader the Constitutional procedure for balancing the federal budget. Had this procedure been included in the Senate Report No. 97-151, it is quite obvious the subversive and fraudulent nature of the balanced budget amendment promoted by Senate Report No. 97-151 would have been exposed, along with the fraudulent call for a Con-Con to balance the federal budget.

The third item which I have included in my report to this committee is a brief review of the debates which took place among those enlightened and sincere representatives who authored the First Revenue Act during the First Congress of the United States. Not only did these gentlemen carry out an America First Policy, and were able to solve the very economic sufferings which our nation now experiences, but they were able to accomplish this without taxing or oppressing America's labor, businessmen, or manufacturers. They accomplished their ends by simply following the principles set forth in the Constitution of the United States of America.

I have affixed to these remarks in the Appendix, a document titled PROSPERITY RESTORED THROUGH THE STATE RATE TAX of which I was the co-author. I have also included in the appendix a summary of research of the Sixteenth Amendment which may reveal to this committee for the first time the documented legislative history that the Sixteenth Amendment as passed by the Congress and ratified by the states has not given any new power of taxation to the Congress of the United States. Its power to reach (through Article 1 Section 8 Clause 1) the profits of corporations by laying a tax on the corporate charter, the tax to be measured by the amount of income produced by the corporation using that charter, or to tax the licenses of lawyers, or to tax the ill-gotten gains of criminals - has never been disputed. But for Congresses to have perpetrated a fraud upon the American people in extending the expired "Victory Tax" from World War II and using the awesome, oppressive, despotic, dictatorial power of an agency known as the I. R. S. to intimidate and make fearful American citizens in order that their property be extorted from them under the guise of paying their "fair share" of taxation to support the government - the Congress of the United States has never been granted a power to tax the people or their property directly unless apportioned. This is proven by Article 1, Section 2, Clause 3, and Article 1,Section 9,Clause 4 of the Constitution which have never been repealed; the Congressional research service, operating for the benefit of our lawmakers through the Library of Congress; through its representative, Mr. Howard Zuritzky, has prepared a report in which he concurs with the research that has been done by myself and others in this country, that notwithstanding the Sixteenth Amendment - there is NO POWER to lay a direct tax upon any individual or upon the property of any citizen of the United States unless it be apportioned according to representation. As was practiced in the past, when the direct tax of 1798, the taxes of 1813, 14, 15, 16, & 17, and the direct taxes of 1861 were laid, in order to reduce the war debts- the war debts of the Revolutionary War, when the debts of the States were assumed by the federal government, then the taxes laid to pay for the cost of the War of 1812, and in 1861 when a direct tax was laid to pay for the cost of the Civil War, only the Northern States paid or were collected from, since the Southern States were in rebellion. In 1891, the Congress recognizing the disproportionate burden of the Northern States to have contributed to the direct tax of 1861 - they refunded to those States that had paid or from whom the tax had been collected, the amounts tendered or received. In 1894 when an attempt was made to lay a direct tax without apportionment - that tax was struck down by the court in the Pollack case - and the Pollack case is still the rule today. Notwithstanding the Sixteenth Amendment.

In the Brushaber and Stanton cases, the Supreme Court articulated that if a tax is direct - it must be apportioned. Therefore, by its own language the Sixteenth Amendment indicates it was a tax not subject to the rule of apportionment, thus it must be subject to the only other rule in existence - that of the rule of uniformity which is applicable only to Indirect Taxes. The Sixteenth Amendment applies to a tax - an indirect tax in the form of an excise tax - therefore it is not applicable against ANY American citizen who works for a wage, salary, fees, commissions, etc., exercising his constitutionally protected right to earn a living.

This fraud and practice by the government must cease. But it will take the effort of an informed Congress to end this evil practice against the citizens of the United States. The present proposals before this Congress of a FLAT RATE TAX, a GROSS INCOME TAX, as proposed by Jim Jones, Kemp-~~Roth~~ Kasten bill, the Bradley-Gephardt Bills would only extend evil practice of the I.R.S. and not follow Constitutional Taxation unless these bills are identified as applying only against lawyers, corporations, or criminals as does the Sixteenth Amendment, (which is only the redundant expression of Article 1, Section 8, Clause 1 of the Constitution). The present proposals before the Congress, such as the Flat Rate Tax, A Gross Income Tax, A Value Added Tax, A National Sales Tax are further abuses on the American people as the Congress no doubt by now, has become aware of the fact that American citizens are doing their own research to learn the present practice of taxation is foreign to any intent of taxing authority to be granted to the Congress of the United States against its citizens. There is, according to the I. R. S., a movement throughout the country whereby people are no longer voluntarily filing "tax-returns" having learned that this is the only way authority over themselves and their property can be granted to the I.R.S. - i.e. by their voluntary submission of a signed 1040. We have heard the word "underground-economy" which again is a demonstration and application of Orwellian language whereby in effect what is truly meant is that because of drug taffic and other illegal activities, prostitution, gun-running, or whatever, that there is an under-world economy since the Congress has the power to tax with one statute that which is made criminal by another. But there is no underworld economy whereby people engaging in an exchange of their labor, which is their property, for money - which is the property of another - and therefore incur for themselves no tax responsibility to the United States government. Jefferson's inaugural address explained quite clearly that in his mind the sum of good government was one that would not take from the mouth of labor the bread that it has earned. It was NEVER intended in the formation of this country that any man should be taxed by his government upon his sweat. We hear this myth that a person only pays their fair share. Since this government was only created and given limited powers, and one of those powers was to provide for a Navy, a military force to protect us against hostile nations - this Union was formed therefore, to protect our liberty. How then, could one man's liberty cost any more than anothers? Where was this country founded upon any such principle - that the more productive a person may be - the more fortunate a person may be because of the productivity of his ancentors - that he was responsible to provide greater support to the government for the protection of his or her liberty?

By following the method of taxation employed by our founding fathers from the inception of this government, we will find that those people who are the wealthiest, and who buy more luxuries than anyone else will pay a greater proportion of taxes by the manner and frequency in which they spend their money. The Flat Rate Tax (with graduations), the FAST Tax, and the Gross Income Tax (Jim Jones - author) proposals is an attempt to change the definition of "Income", to permit the taxing of American sweat. The Supreme Court definition of income does not include the wages, salaries, fees, or compensation for services for unenfranchised Americans who have exchanged their labor (property) for money (property) in the pursuit of their constitutionally protected right to earn a living.

Congress cannot define income. The U.S. Supreme Court has held:

> ...it becomes essential to distinguish between what is, and what is not"income"...Congress may not, by any defintition it may adopt, conclude the matter, since it cannot by legislation alter the Constitution from which it alone derives its power to legislate, and within whose limitations alone, that power can be lawfully exercised.

Eisner v. Macomber, 252 US 189 (1920)

The sixteenth amendment allows an "excise tax" only on "gains" and"profits" earned through the exercise of a government granted privilege or criminal activities.

Present IRS interpretations are actually directed towards collecting a direct tax on both the source and the income, in regard to all forms of compensation, when the law allows only for an indirect tax in the form of an excise upon income.

The misapplication of the law practiced by the IRS with the tacit approval of the Congress and the Judicial system permits governmental rape of the personal and business finances of America.

Are we supposed to be of good cheer that the Congress is looking into new proposals for the collecting of taxes? Is the action of the Congress arising from a concern that the tax system is unfair and oppressive? Or is it because more and more Americans are becoming informed that they don't owe an income tax and are walking away from economic slavery despite the threats and abuses of the IRS?

The Congress promises tax reform. The dictionary reminds us that "reform" is an attempt to correct that which was corrupt from the beginning.

It matters not whether the conditions that exist are the intentional or accidental fault of the members of Congress. They have taken an oath to uphold the Constitution and obey it and they are in violation of that oath in many ways and not just in matters of taxation.

For months we have heard that any plan now proposed, if adopted must produce the same amount of taxes at a minimum. This does not take into consideration the vast expenditures of monies for objectives for which there is no constitutional authority whatsoever. This monetary goal demonstrates the total lack of concern by the Congress to restrict itself to spending only as constitutionally authorized.

The Congress is guilty of permitting the IRS to criminalize citizens who only want to protect their property from a confiscatory government.

It is the present membership of the Congress that needs to be replaced and not a tax collection system. Impeachments should be sought against those who continue to violate their oaths of office and those who are currently standing for office should be struck down at the polling booths.

We have Senators who have been better educated in the provisions of Parliamentary government such as that practiced in England than have been taught the intent of the Framers who wrote the Constitution, the Law of the Land.

The best thing to come out of Washington in many decades is the Grace Commission Report and that contains sufficient evidence of the abuses of the Constitution concerning fiscal practices of the stewards of government.

The Congress is supposed to be composed of our public servants and not our masters. Other abuses of the Constitution and violations of trust will be addressed in my soon to be published book, " Congress In Rebellion".

In closing may I remind this committee that over fifty years ago, Will Rogers said, "There is no organized crime in the United States except for the Congress of the United States.", and I submit that the criticism is still valid today.

Gentlemen, the plan for taxation which I submit before this committee is in fact, the Constitution of the United States of America.

Respectfully submitted,
Edward A. Ellison, Jr.
Edward A. Ellison, Jr.
Free State Constitutionists
6509 York Road
Baltimore, Maryland 21212

APPENDIX

1. An America First Policy
2. A Second Constitutional Convention, Will It Happen?
3. Prosperity Restored Through The State Rate Tax.
4. Balanced Budget in Constitution - Article published in SPOTLIGHT 3/26/84

by:

Edward A. Ellison, Jr.
and
John William Kurowski

It is a commonly accepted fact, that a tax upon the earnings derived from our nation's labor, manufactures, agricultural industry and small businesses, is a tax upon production; that a tax upon production__impairing a free exchange between labor and industry__increases the price of our articles exported; that an increase in the price of our nation's exports is destructive to America's ability to compete in foreign trade, and thus, a tax based upon the earnings of production is not only oppressive, it is not in the best interests of the United States.

To obtain a national revenue, from which to discharge the national debt, provide for our nation's common defense and fund those constitutionally authorized objectives which are enumerated in our Constitution, and, which *" shall not be oppressive to our constituents"*, it is imperative that all federal revenue currently contributed by America's labor, agricultural industry, manufactures, and small businesses, calculated from their earnings, be suspended, and necessary revenue be raised from other sources, to wit:

(1) That articles of consumption, both domestic and imported, such as cigarettes, spiritous liquors, jewelry,

(articles of consumption which are of a purely luxurious nature), ought to have an inland excise tax added to their consumption; taking into account the price of similiar articles imported, and adjusting the tax on each specific article so both may compete in our market on a fair and equal basis, while bearing in mind that an excessive tax upon such articles will reduce consumption and diminish a just source from which to fill the national treasury. A tax upon articles of this nature *(luxury),* allows each person to contribute to government by the manner and frequency with which he spends his/her money.

(2) Imported goods which are not of a purely luxurious nature, which can be, or are, manufactured in America, ought to be taxed on their import with a view to encourage and protect American manufactures, which will promote *fair trade,* as opposed to *free trade.* The principles to be taken into consideration in the selection of imported articles to be taxed, and the rate at which each imported article ought to be taxed, are these:

(a) Imported articles which are produced by slave labor (*a labor situation in which the inalienable right of individuals to contract out their own labor as they see fit is denied them without just cause)* ought to be taxed to protect the standard in our country which guarantees each citizen's freedom to contract out their labor. Failure to impose a tax on imported articles produced by slave labor, is not only unfair to our nation's labor, *but will leave our nation's manufactures in an unfair competitive situation.*

(b) Articles of consumption such as steel, aircraft, computers, vehicles used to facilitate internal and external commerce, tools of production, farm equipment, military provisions, etc. (*all being necessary to the internal strength of our nation)* ought to be taxed when imported with a view to encourage and protect domestic manufacture of such articles. Imposts and duties upon imports in this class are justified upon the principle of *national security; that the United States must never become so dependent, or interdependent, upon foreign manufactures as may weaken our internal manufacturing capabilities as may endanger our nation's general welfare if foreign trading partners should suddenly become hostile toward America, or intimidated by other hostile foreign powers.*

(3) In addition to the above mentioned taxes on consumption, a tonnage tax upon the freight of foreign vessels importing articles of consumption is a proper method to:

(a) regulate trade with foreign nations;
(b) secure a national revenue;
(c) encourage the growth and protection of American owned carriers which are employed in foreign trade;
(d) protect American manufactures from unfair trade.

Vessels and aircraft employed in foreign trade being built in the United States, and belonging wholly to a citizen or citizens thereof, ought to be given a preference at our ports of entry. The principle upon which a tonnage tax upon the freight of foreign carriers ought to be imposed, must take into account the nations with whom America trades; their policy on import taxation upon articles of consumption which America produces for export; and any preference these foreign nations may give to carriers over our nations carriers .

Applied properly, such a tax will provide a source from which to draw a national revenue; will greatly enhance a fair trade between America and foreign nations, particularly those nations exporting into our country virtually duty free, but are quite protective and discriminatory when it comes to accepting America's exports on an equal footing. This tonnage tax upon the freight of foreign imports will also provide a necessary mechanism to protect America's vital manufactures which is essential to America's internal strength.

(4) An internal tax, not mentioned above, and proper in its application, is an excise tax upon domestic carriers when employed in interstate commerce, but only justified in certain and *limited* cases:

(a) to insure safe passage of carriers as they pass from state to state (i.e., federal jurisdiction to prosecute and penalize hijackers, pirates, etc.);

(b) inspection for contamination of food stuffs and raw agricultural produce;

(c) saftey measures for hazardous materials being shipped from state to state.

The principle justifying the above described tax is not one of raising revenue, but rather, only to raise necessary funds to pay for the cost of federal policing of interstate commerce as above mentioned . . . be it understood that each carrier is to bear its own just proportion as related to the cost of federal protection rendered as applicable to the specific policing service afforded. No other kind of federal tax upon interstate carriers can be justified, and, as such, *all other federal taxes which now increase the cost of interstate trade, increase the cost of articles of consumption; are oppressive to production; damaging to the United States in their competition for foreign trade, and ought to be immediately suspended.*

Having offered an *America first policy* by which to raise a national revenue, *beneficial to America's labor, manufactures, agricultural industry and small businesses,* the question remains as to the retirement of the national debt.

Under the proposed plan, if the annual expenditures of Congress exceed the revenue raised from imposts, duties and excises, then, ***Congress shall*** impose the *State Rate Tax* in order to preclude Congress from adding a year end deficit to the national debt.

The State Rate Tax is a direct tax required to be imposed if an annual deficit occurs. This tax is to raise a sum certain (annual deficit), and each State will be required to contribute a share calculated upon its number of representatives (votes) in the House of Representatives. The tax is to be used only if imposts, duties and excises fail to meet Congress' annual expenditures.

Upon imposition of the State Rate Tax, the Secretary of the United States Treasury, to extinguish an annual deficit, would submit a bill to each state's capitol for its apportioned share of this deficit. Each state would be left free to raise its apportioned share within a time specified by Congress. In the event there is a surplus of money in the United States Treasury at the close of a fiscal year (i.e. ther is no deficit), this surplus would be applied to a *sinking fund* to reduce or extinguish the national debt. If there is no deficit, nor a national debt, any surpluses raised from imposts, duties and excise taxes may be returned to the states by the same rule of apportionment.

Ed. Note. A copy of "Prosperity Restored by the State Rate Tax" may be obtained by contacting authors.

FORMULA FOR COMPUTING EACH STATES' APPORTIONED SHARE OF DIRECT TAX

$$\frac{\text{States' No. of Representatives (votes) in House of Representatives}}{\text{total number of Representatives in House of Representatives}} \times \text{amount needed, not fundable by federal indirect taxes (imposts, duties, excises)} = \text{States' share of S.R.T.}$$

MATHEMATICAL COMPUTATION FOR THE STATE OF MARYLAND FOR A $ 100,000,000 DIRECT TAX APPORTIONED AMONG THE STATES (STATE RATE TAX)

$$\frac{\text{Md's No. of votes in House of Reps.}\quad 8}{\text{total No. of Reps. in House of Reps}\quad 435} = 1.839 \times \$\,100,000,000. = \$\,1,839,000.$$ Maryland's share of apportioned tax

The following chart shows the current rate of apportionment for a few States. This chart demonstrates each States' obligation under the State Rate tax, or, the returnable amount due to the State if federal indirect taxes have exceeded the annual expenditures of Congress. The chart is based upon a $100,000,000. returnable surplus, or the same sum certain to be laid as an apportioned direct tax:

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NOTE: Under the rule of apportionment, Washington, D.C. not being a State, and not having a vote in Congress, is not subject to the State Rate Tax.

BULLETIN

COMMITTEE TO RESTORE THE CONSTITUTION™

#255

Archibald E. Roberts.
Lt. Col., AUS. ret., Director CRC

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SECOND CONSTITUTIONAL CONVENTION

CITIZENS PETITION FOR REPEAL OF MARYLAND'S CALL FOR CONSTITUTIONAL CONVENTION

Rescinding Maryland's call for a Constitutional Convention to balance the Federal budget is the goal of Edward Ellison and John Kurowski who lead a State petition drive to defend and preserve the Constitution of the United States.

By complying with emergency taxing power in the Constitution, Article 1, Section 2, Clause 3, they say, Federal lawmakers can immediately affect an annually balanced Federal budget without the risk of a constitutional convention.

Fearing loss of freedoms of person and property posed by the constitutional convention syndrome, a growing body of alarmed citizens ask for a review of their State involvement in the balanced budget stampede.

The emotionally-charged issue, hysterically promoted by the National Tax-payers Union, 325 Pennsylvania Avenue, SE, Washington, DC, and other groups fronting (knowingly or unknowingly) for world government advocates, may result in replacing the Constitution of the United States with a soviet-style Constitution for the Newstates of America (March 1984 CRC bulletin).

A Newstates Constitution exists! Funded by the Rockefeller Foundation and produced by the Center for the Study of Democratic Institutions, Santa Barbara, California, it awaits implementation by a captured Congress.

A constitutional convention would provide the appearance of legality and opportunity for eliminating the Constitution, now a bar to one world government sponsors.

Ill-considered state memorials alleging balanced budget purposes polarize public frustration and channel political momentum toward a catastrophic conclusion.

Challenging civil and private revolutionaries, Ellison and Kurowski explain what dedicated citizens in sister states may do to derail the rush toward a constitutional convention.

The argument for reconsideration, based on constitutional authority, is set out in their handbook, "A Second Constitutional Convention—Will it Happen?", extracts reprinted below, and PETITION BEFORE THE MARYLAND GENERAL ASSEMBLY, reproduced in full.*

A SECOND CONSTITUTIONAL CONVENTION

Only two State's Legislatures approval is now needed to demand that a Constitutional Convention take place for the illusory purpose of *"balancing the federal budget."* This puts our Nation at a crossroad which will separate true patriotic Americans who have read their Constitution and are aware it already commands the federal budget is required to be balanced, from those who have not read the Constitution and fail to recognize the Constitution clearly mandates that Congress shall balance its budget.

Surely, the call for a Constitutional Convention is not a liberal or conservative issue, nor is it exclusively being promoted by democrats or republicans. It is, however, a very serious matter in which the *truth ought to be spoken and made available to the general public at all costs.* Why? Because the freedoms which American Citizens now enjoy, and have foolishly taken for granted for so many years, may very well be unjustly compromised if a constitutional convention should take place. On the other hand, if Congress is not immediately compelled to obey the Constitution, requiring sound fiscal policies, a constitutional convention may be forced which could jeopardize our most sacred freedoms.

To understand the real threat of allowing a constitutional convention to take place, it is important to recall what almost took place in New York in 1967. During the mid-1960's, a constitutional convention was called to amend New York's Supreme law. At the time, a small group believing the government's power of taxation ought to be used to aid religious schools, was successful in pressuring delegates to the convention to adopt no constitutional prohibitions against such aid. Fortunately, in view of the threat that government aid eventually leads to dependency upon government, which in turn allows the government's power of the purse to be used to impose regulations and controls over those who become financially addicted, the citizens of New York had the final say by popular vote, which is required to amend New York s Constitution.

After the vote was counted to approve or disapprove what the delegates to the convention thought best for the People, the People of New York disagreed with their delegates by over 72 per cent! The financial independence of religious schools was thus saved from possible government take-over through the power of

(continued page 2)

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*Permission, Edward A. Ellison, Jr., and John William Kurowski, 9104 Edmonston Court, #301, Greenbelt, MD 20770 (301) 345-5689.

the purse. But, only because the People had the final say by their popular vote on any changes to be made to their State Constitution.

Following a constitutional convention, in which the United States Constitution and its Bill of Rights could have been totally rewritten and destroyed, the ratification process does not permit the People to have the final say through a popular vote. Although the People may disagree with their State Delegates and Legislators by a 72 per cent margin—as they did in New York—a popular vote in each of the States is not necessary for the States to ratify what State Legislatures may think are appropriate or expedient changes to be made to the Constitution of the United States.

There are two ways by which to amend the Constitution of the United States, as stated in Article V of the United States Constitution:

ARTICLE V.

> The Congress, whenever two-thirds of both Houses shall deem it necessary, shall propose Amendments to this Constitution, or, on the Application of the Legislatures of two-thirds of the several States, shall call a Convention for proposing Amendments, which in either Case, shall be valid to all Intents and Purposes, as part of this Constitution, when ratified by the Legislatures of three-fourths of the several States, or by Conventions in three-fourths thereof, as the one or the other Mode of Ratification may be proposed by the Congress; Provided that no Amendment which may be made prior to the Year One thousand eight hundred and eight shall in any Manner affect the first and fourth Clauses in the Ninth Section of the first Article; and that no State, without its consent, shall be deprived of its equal Suffrage in the Senate.

Simply put, the Constitution can be amended in one of two ways: the first is by a proposed amendment(s) being offered to the States by Congress, which are limited to one specific issue, and if ratified by three-fourths of the States becomes law. The other is by a Constitutional Convention being demanded by two-thirds of the State Legislatures, in which case the entire Constitution and its Bill of Rights could wind up being rewritten, and if approved by three-fourths of the States becomes law.

Herein lies the dividing line between those who want the Constitution followed, and also want a balanced budget, from those who would allow our Republic's most precious document to be tinkered with by State politicians, before establishing the truth. The question is: Will truth prevail, or will truth be ignored allowing 38 State Legislatures to do as they please?

In support of the truth, a review of the debates held in Convention during the framing of our Constitution—specifically those which eventually produced Article 1, Section 2, clause 3, and Article 1, Section 9, clause 4—are essential reading for all who believe a constitutional convention is necessary to *"balance the federal budget."* The fact is, *the Constitution already commands the budget to be balanced!* Not only is this true, but the balanced budget clause of our Constitution, Article 1, Section 2, clause 3, has been imposed a number of times in our Nation's history (see appendix A) (deleted), and is today being ignored by the very leaders who are calling for a convention to balance the budget.

The balanced budget clause of our Constitution reads in part:

> *"Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union . . . "*

This article of supreme law vests Congress with an emergency power demanding a direct tax to be laid upon the State Governments, (in proportion to each State's voting strength in Congress) if the constitutionally authorized expenditures of Congress exceed the revenue raised from impost and excise (indirect) taxes.

In disobedience of this Constitutional Command, Congress now borrows to finance its deficits, then taxes to pay the interest on borrowed money, instead of taxing the State Governments to finance said deficits which would immediately end accumulated deficits, and save American Citizens billions of dollars per month interest payments which they now pay on borrowed money.

Although it is true that Congress has been granted power to borrow money, the exception to, and the Constitutional restriction placed upon this borrowing power, is that *Congress may not borrow to finance a deficit!*

On an annual basis, a deficit may be described as the amount of money Congress spends, and/or borrows, during a fiscal year in excess of the amount of money brought in from indirect taxes (imposts and excises) during that year. This fiscal year, Congress has managed to borrow and spend approximately $180 Billion more than it has brought in. To finance this deficit, Congress will simply borrow money which will eventually be taxed away from the American People. Having borrowed this money, the American People will now be taxed, in addition to the $180 Billion, over $11 Billion per month to pay interest on the money borrowed by Congress. This action of Congress increases the public burden of taxation in violation of the balanced budget clause of the United States Constitution!

In effect, the American People are now being taxed, in violation of the Constitution, over $130 Billion per year to pay interest on borrowed money, and pay these Billions of dollars before one dime of collected tax revenue is used to provide for our Nation's common defense or promote our general welfare. Why? Because Congress ignores the intent of our Constitution, and those who call for a balanced budget, they fail to realize a balanced budget clause already exists in our Constitution, waiting to be enforced, which would instantly cure Congress' current irresponsible, reckless and criminal fiscal policies.

During the Constitutional Convention of 1787, a thorough reading of the debates which took place in Convention, clearly shows that Article 1, Section 2, clause 3 (the balanced budget clause), was specifically adopted to insure fiscal responsibility and honesty from a Congress about to be given life. Equally true is the fact that the State Ratifications, signed by the original thirteen States of our Union, echo this point quite clearly. For example:

STATE OF MASSACHUSETTS

In Convention of the delegates of the People of the Commonwealth of Massachusetts February 6th 1788

Fourthly, That Congress do not lay direct Taxes but when the Monies arising from the Impost & Excise are insufficient for the publick exigencies nor then until Congress shall have first made a requisition upon the States to assess levy & pay their respective proportions of such Requisition agreeably to the Census fixed in the said Constitution; in such way & manner as the Legislature of the States shall think best, & in such case if any State shall neglect or refuse to pay its proportion pursuant to such requisition then Congress may assess & levy such State's proportion together with interest thereon at the rate of Six per cent per annum from the time of payment prescribed in such requisition

This same language is also found in several other Resolutions signed by the original thirteen States by whom the Constitution of the United States was ratified. (See Appendix B for South Carolina and New Hampshire Ratifications.) (deleted)

Congress is in fact commanded to lay a direct tax upon the State Governments (the State Rate Tax) if "... *Monies arising from the Impost & Excises are insufficient for the publick exigencies ...*"

If followed today, not only would Congress be compelled to end each fiscal year with a balanced budget, but, irresponsible spending and inequitable taxation by Congress would instantly be ended! Why then, call for a constitutional convention to balance the budget, when the Constitution already contains the provision? Is there a better plan being offered by those who call for a convention? Is there a defect in our Founding Father's solution, or mischief in the air?

Contrary to the belief that fiscal restraint was not addressed by the Framers of our Constitution, the foregoing facts cannot be changed to what they are not. A balanced budget provision already exists which will render Congress fiscally responsible if and when the People demand it be followed.

The real problem, if one exists, is that we have dishonest legislators, conservatives and liberals, republicans and democrats, masquerading as fiscal conservatives who disobey the intent of our Constitution; have conned American Patriots around the country into believing a Constitutional Convention will restore fiscal responsibility in Congress Assembled; and have requested financial contributions be made for such a cause. But some, as we should like to believe, are simply misinformed, and are now beginning to withdraw their support for a Constitutional Convention in favor of the truth!

It is a fundamental principle of constitutional law, that legislative intent must be established when determining what the Constitution means. To follow the Constitution, is to carry out the intentions of the authors of, or parties to the written instrument ... these intentions are found in the debates during which time the Constitution was framed, and were recorded by James Madison and others.

In the instant case, the delegates of the States sent to the Convention of 1787 (the Authors of our Constitution), and, the parties to the Constitution, (the States), clearly intended, as exhibited in the delegates' debates during the convention, and also the ratification documents signed by the States, that if the expenses of Congress should not be met by the revenue raised from imposts and excise taxes (indirect taxes), that Article 1, Section 2, clause 3, (the State Rate Tax) would be imposed:

The balanced budget clause of our Constitution is now being disobeyed by a rebellious Congress, which now engages in unconstitutional and criminal borrowing practices: practices which have become so evil in nature that the very existence of the United States, and our general welfare, is now threatened by a nationwide financial collapse.

The emergency taxing power contained in Article 1, Section 2, clause 3, of the United States Constitution, was granted to Congress for a number of reasons; to extinguish the debt of the Revolutionary War; to preclude Congress from accumulating year-end deficits through borrowing; to insure Congress had adequate taxing authority in the event an emergency should arise whereby indirect taxation might be found insufficient to meet such an emergency. But, equally important, this article of Supreme Law was meant to prevent a factious majority in Congress from destroying our Republic financially, by using its voting strength to increase the tax burden upon those whom they could outvote, without also increasing their own burden of taxation in a similar fashion. *(See Pollock v. Farmers' Loan and Trust, 158 U.S. 601; 1894)*

The very practices forbidden by our Constitution are now joyfully engaged in by a criminal element in Congress, and are the roots from which todays irresponsible spending, inequitable taxation, uncontrollable borrowing, and year end accumulated deficits have grown. Every evil associated with democracies of the past, which has led to their predictable financial destruction, is now commonly practiced by our public trustees in violation of the Constitution they have sworn to uphold, and which governs our Constitutional *Republic.*

The leading evil associated with democracy (mob rule government) is that the rights of an individual or minority cannot be protected against the omnipotent majority, and that as soon as the people learn they can use the political system to vote and tax away the property of their neighbor, they do so. Consequently, the societies' productive base is then slowly eaten away until there is no productive base left. Generally, as history proves, it is at this point when economic conditions are at their worst, that the mass of the people will submit themselves to any form of government which promises relief from their sufferings. Our Nation is now sitting on that borderline. Will we be so foolish to allow a Constitutional Convention to take place when our Constitution already demands Congress is to balance its budget?

In conclusion: From 1787 to the present, there's been no need to call for a constitutional convention. Twenty-six amendments are evidence of this fact. If the true purpose of the leaders who are pushing for a constitutional convention is indeed a limited one, and confined to "balancing the federal budget", then why not simply demand the existing balanced budget clause of the United States Constitution be enforced? Ought not such an attempt first be made before proceeding into the uncertain areas of a full blown constitutional convention, and flirting with the dangers involved therein?

The Framers of our Constitution indicated in the notes on the debates as recorded by Madison, that their conduct, from the time of abandoning the purpose of amending the Articles of Confederation, to writing a new constitution, was criminal and exceeded any authority with which they had been commissioned. Thereupon, their first act was an agreement that all discussions and proceedings of the convention were to

(continued page 4)

be kept absolutely secret. Is there any doubt this practice would not be repeated if a constitutional convention is convened now?

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America could not participate in a world government and retain the protection or guarantees of our Constitution because such a constitution would be in conflict with any set of rules used in the governing of all nations under one controlling oligarchy. Freedom as enjoyed by Americans is not enjoyed to such degree any where else in the world, and such freedom would be a contradiction under a global government controlled by power brokers and/or international bankers. America is threatened by the greater clear and present danger of a Constitutional Convention than was ever posed by her exposure in World War I, II, the Korean or Vietnam conflicts. The arousal of the people to demand obedience to the Constitution by Congress, the Executive and the Judiciary, is the only method for the saving of America to perpetuate for Americans the liberty and freedom upon which this Nation was founded.

DEFEND AND PRESERVE THE CONSTITUTION!

Adapt Maryland Petition to rescind/prohibit participation by your State in constitutional convention to balance Federal budget.

PETITION

Before the Maryland General Assembly

Annapolis, Maryland

1984

We, the people of Maryland, hereby petition our State Legislature to adopt Resolutions as affixed hereto, by which the State of Maryland:

1. Will rescind Maryland's existing call for, and/or participation in, a Constitutional Convention to balance the federal budget;

2. Will demand the United States in Congress Assembled in order to balance the federal budget to immediately comply with, and utilize, the emergency taxing power authorized by Article 1, Section 2, Clause 3 of the existing federal Constitution; said Article of Supreme Law having already been debated at great length during the Constitutional Convention of 1787, and agreed by the States to be the equitable and least corruptible method by which to effectuate a balanced federal budget!

PROPOSED RESOLUTIONS

RESOLUTIONS ADOPTED

1984

by

The General Assembly of Maryland

for the purpose of:

I Rescinding Maryland's call for and/or participation in a Constitutional Convention to balance the federal budget:

II Demanding that Congress Assembled comply with and utilize the emergency taxing power of Article 1, Section 2, Clause 3 of the United States Constitution to immediately effectuate an annually balanced federal budget!

WHEREAS, the Congress of the United States is in rebellion against the Constitution of the United States.

WHEREAS, the Congress of the United States Assembled has failed to conform to the fiscal restraints of the Constitution of the United States.

WHEREAS, the Constitution of the United States commands that when monies raised by federally imposed Duties, Imposts and Excises are insufficient to meet the public exigencies, a Direct tax must be laid by Congress, apportioned among the States, as prescribed by Article 1, Section 2, Clause 3, to extinguish the deficit, and thereby "balance the annual federal budget;"

WHEREAS, the Congress of the United States Assembled has accumulated unfunded debt liabilities which now exceed eight (8) trillion dollars;

WHEREAS, the Congress of the United States Assembled has in violation of the federal Constitution practiced the borrowing of debt contrary to the grant of power to borrow money upon the pledge of public credit;

WHEREAS, the Congress Assembled has unlawfully burdened our Nation's succeeding generations with needless interest payments on debt, now at a yearly rate in excess of 120 Billions of dollars per year;

WHEREAS, Congress Assembled has made no provision to extinguish the principle of said debt;

WHEREAS, Congress Assembled now spends 120 Billions of dollars per year from collected tax revenue to pay interest payments before collected tax revenue is used to provide for our Nation's common defense or the general welfare of the United States;

WHEREAS, such circumstances now threaten to destroy the very existence of Maryland's economic enterprises, and the economic freedom of her citizens;

RESOLVED, that the State of Maryland hereby rescind Her call for a Constitutional Convention, and/or participation in a Constitutional Convention to "balance the annual federal budget."

RESOLVED, that the State of Maryland demands that the Congress of the United States Assembled follow Article 1, Section 2, Clause 3 of the United States Constitution to extinguish any annual deficit which would arise when revenues of Duties, Imposts, and Excises collected under the grant of taxing power contained in Article 1, Section 8, Clause 1 are insufficient to meet the public exigencies (those Constitutionally authorised objectives) thereby balancing the annual federal budget;

RESOLVED, that if Congress Assembled fail to obey the Constitution so as to balance the annual federal budget, that the State of Maryland, by the direction of Her Governor, through the office of Her Attorney General, will charge the Congress as being in rebellion and of treasonous conduct;

RESOLVED, that the State of Maryland recall her representatives and replace them with others who will uphold their oath of office to support and obey the Constitution, bringing suit against Her former representatives in their personal capacity under Article 1, Section 6, for their treasonous conduct;

RESOLVED, that the Legislature of Maryland have adopted these Resolutions to rescind Maryland's call for, and/or participation in, a Constitutional Convention so that the peace, dignity and Government of the State of Maryland may be preserved.

PROSPERITY RESTORED BY THE STATE RATE TAX

Unlike any of the political party gimmicks and schemes currently being offered by career politicians, the State Rate Tax is part of a plan to remedy outright dishonesty, now practiced by the Congress of the United States. As you will see, this plan is not simply another tax proposal, nor a political party creation to maintain the current status quo. It is a revolutionary concept to introduce checks and balances linked to taxation, which will terminate reckless spending by Congress; arrest year end deficits accumulated by Congress; and, preclude inequitable taxation which has been institutionalized by political party loyalists.

Under this plan, the control of Congress is in part achieved by immediately requiring all federal expenditures to be met by *indirect taxation,* imposts, duties and excises. Imposts are taxes imposed on imported goods or merchandise; duties are custom charges levied on things brought into the country; excise taxes are inland impositions upon articles of consumption (alcholic beverages, cigarettes, gasoline, etc.) manufactured for sale or consumption within the country. Excise taxes may also be imposed on *illegally earned income (gains or profits); upon income earned under licenses granted by government, or upon income earned through a specific privilege which government has been delegated power to authorize.*

The theory behind funding government functions from taxes laid upon articles of consumption, is that citizens are ~~to~~ be free to contribute to government in the manner and frequency by which they spend their money.

Taxes on articles of consumption, it must be noted, contain their own check and balance against political corruption, and are the least oppressive of all taxation. A tax on articles of consumption, says Hamilton, number 21, Federalist:

> " . . . may be compared to a fluid, which will in time find its level with the means of paying them. The amount to be contributed by each citizen will in a degree be at his own option, and can be regulated by an attention to his resources. The rich may be extravagant, the poor can be frugal; and private oppression may always be avoided by a judicious selection of objects proper for such impositions. (I)t is a Signal advantage of taxes on articles of consumption that they contain in their own nature a security against excess. They prescribe their own limit, which can not be exceeded without defeating the end proposed__that is, an extension of the revenue."

If any particular article of consumption is excessively taxed, it would reduce the volume of its sales and the raising of revenue would be eluded. This *check and balance* will determine the limit to which each selected article may be taxed. By forcing Congress to select *specific articles of consumption*, as opposed to a *blanket national sales tax*, a system of taxation is achieved in which the general public may actively participate in the selection of the specific articles to be taxed, and, to what degree they will be taxed.

If, for example, Congress laid a twenty dollar per pound tax on all imported caviar sold in the United States, (an excessive tax even for a luxury article) the wealthy, and merchants dealing in this product would undoubtably cry "foul" and withdraw their political support from those representatives responsible for the imposition of an excessive tax on caviar. If, however, the tax were moderated to a tolerable level, the purchaser's resistance would also diminish and revenue would be generated!

Another important advantage to labor and industry, when revenue is raised by taxes on *specific* articles of consumption, is that the necessities of labor (food, shelter, clothing, etc.) tools of production, and supplies necessary to conduct business may be excluded from the tax list. This will allow industry and business to flourish unimpeded by taxation; employment to expand, and the welfare of our States' commerce to be actively protected from oppressive taxation.

Under the proposed State Rate Tax plan, the expenses of the federal government__those specifically authorized by the Constitution of the United States, which are clearly enumerated and subjoined to Article 1, Section 8, Clauses two through eighteen__are to be funded by indirect taxation! If the annual expenditures for these Constitutionally authorized functions of Congress exceed the revenue raised from imposts, duties and excises, then, and *only then*, shall Congress be required to impose the State Rate Tax in order to preclude Congress from adding a year end deficit to the national debt.

The State Rate Tax is a direct tax required to be imposed if an annual deficit occurs. This tax is to raise a sum certain (annual deficit), and each states' share is to be calculated upon its number of representatives (votes) in Congress. The tax is to be used only if imposts, duties and excises fail to meet Congress' annual expenditures.

Upon imposition of the State Rate Tax, the Secretary of the United States Treasury, to extinguish an annual deficit, would submit a bill to each states' capitol for its apportioned share of this deficit. Each state would be left free to raise its apportioned share within a time specified by Congress. In the event there is a surplus of money in the United States Treasury at the close of a fiscal year (i.e. there is no deficit), this surplus would be applied to a *sinking fund* to reduce or extinguish the national debt. If there is no deficit, nor a national debt, any surpluses raised from impost duties and excise taxes may be returned to the states by the rule of apportionment.

$$\frac{\text{States' No. of Representatives (votes) in House of Representatives}}{\text{total number of Representatives in House of Representatives}} \times \text{amount needed, not fundable by federal indirect taxes (imposts, duties, excises)} = \text{States' share of S.R.T.}$$

MATHEMATICAL COMPUTATION FOR THE STATE OF MARYLAND FOR A $ 100,000,000 DIRECT TAX APPORTIONED AMONG THE STATES (STATE RATE TAX)

$$\frac{\text{Md's No. of votes in House of Reps.}\ \ 8}{\text{total No. of Reps. in House of Reps}\ \ 435} = 1.839 \times \$\,100{,}000{,}000. = \$\,1{,}839{,}000. \ \text{Maryland's share of apportioned tax}$$

The following chart shows the current rate of apportionment for a few States. This chart demonstrates each States' obligation under the State Rate tax, or, the returnable amount due to the State if federal indirect taxes have exceeded the annual expenditures of Congress. The chart is based upon a $100,000,000. returnable surplus, or the same sum certain to be laid as an apportioned direct tax:

STATE	NUMBER OF REPRESENTATIVES (votes in Congress Assembled)	APPORTIONMENT RATE OF TAX OR AMOUNT TO BE REFUNDED
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NOTE: Under the rule of apportionment, Washington, D.C. not being a State, and not having a vote in Congress, is not subject to the State Rate Tax.

STATE RATE TAX ENDS FISCAL IRRESPONSIBILITY

Among the many benefits offered by the State Rate Tax is its ability to control Congress' current reckless fiscal policies. If Congress remains fiscally irresponsible and attempts to use its *limited power of taxation* to be benevolent at home or abroad, or finance ventures that are not *Constitutionally authorized*, or ignores the command that annual deficits are to be cancelled at the close of *each fiscal year*, the consequences of such actions will immediately pose a political threat to each states' current administration. In the former case, if Congress continues to exceed its constitutionally authorized objectives, requiring the imposition of the State Rate Tax to extinguish a deficit so created, the financial strain on the state treasuries will become so overtaxed that a politically undesirable burden will be repeatedly thrust upon the existing state legislatures, causing them to increase state taxes to fund Congress' unlawful expenditures. In the latter case, if Congress should ignore the command that an annual deficit is to be cancelled at the close of the fiscal year, and votes to borrow to fund this deficit, the accumulated deficits will rapidly mount and hang over the heads of each states' legislators like an axe, ready to be apportioned at any time and deplete the State Treasury.

In either case, if a states' Congressional Delegation decides to follow reckless fiscal policies while in Washington, D.C., the consequences of such policies will place a threatening political liability upon the Governor of that State and its Legislators, forcing them to bear the burden of increasing state taxes, or, they may promote their own political future by demanding a recall of their States' reckless spenders. This check and balance will stimulate the Governers of each state and their Legislators, to keep a jealous eye on the spending policies of their representatives sent to Washington, D.C., and will act as a safeguard to insure that a states' Congressional Delegation will vote the financial limitation which its own state can bear.

TAKING STOCK IN AMERICA

One of the most damaging things to America's labor, small businesses and manufactures, is Congress' reckless policy of borrowing money which needlessly and destructively increases our national debt by billions of dollars each week!

Instead of America's monied interest being asked by Congress to take stock in America by investing in the modernization of her small businesses and manufacturers, so they may once again compete with foreign competitors, provide employment for Americans and restore America's strength and ability to produce her own articles of consumption__all of which makes for a healthy nation__Congress through the Department of the Treasury, auctions off billions of dollars in interest bearing government securities each week, to a special monied class cartell. Among this monied class special interest group are foreign financiers who rush to purchase United States Securities, while Americas' labor, small businesses and manufactures will not only be taxed to pay back this borrowed money, but the interest thereon which now amounts to over 11 billion dollars per month!

The sad truth is, Congress is using its power of taxation and borrowing in a perverted fashion, not to provide for America's common defense or promote its general welfare, but rather, Congress is using its powers to bleed America's small businessman, and laboring class citizen, to pay financial dividends to an affluant class who invest in government securities, and use their interest profit to modernize the industrial enterprises of communistic nations such as Red China, where slave labor exists. Why is it that patriotic Americans, after taxation, have not a dime left with which to take stock in America and modernize her industrial enterprises? Who was it that stated "If treason be profitable, let none dare call it treason?"

Because Congress has been left unchecked, and allowed to engage in unmonitored spending and borrowing sprees, Americas' labor and industry is now paying over $130 billion per year in needless interest payments on borrowed money, and pay this interest *before one dime of collected revenue is used to provide for our nations' common defense or promote the general welfare of the United States.*

This irresponsible borrowing by Congress has placed the United States in an extremely hazardous situation, while it has happily increased the profits of international bankers and financiers to the tune of over $11 billion per month!

The enormous interest payments now paid by American Citizens, because of Congress' politically expedient lust for borrowing, causes the private sectors' investment capital to dry up, interest rates to skyrocket and investment credit for business and industry to become unaffordable. This never-ending-borrowing by Congress has impaired the growth of Americas' small businesses, has helped to create unemployment in almost every state, and has forced a number of our states' largest industries to either flee our country or go bankrupt.

Under the State Rate Tax plan, the accumulation of federal deficits and reckless borrowing to fund these deficits will become a nightmare of the past, and Congress will no longer be free to engage in borrowing policies detrimental to the States need to expand and modernize their industrial enterprises.

STATE RATE TAX SAVES AMERICAN CITIZENS BILLIONS

The annual cost of maintaining a federal income tax collection agency (IRS) whose budget is about $3 billion, would be almost totally abolished, and the annual cost to the nation, both in time and resources, to record confidential financial transactions of our nations' entire population, *under a pretext of raising revenue,* would also be ended by the State Rate Tax.

POLITICAL DISUNITY IN AMERICA REDUCED

The State Rate Tax, because it is a tax imposed upon the state governments by a *fixed formula, and not upon people or their property,*will abolish the present system of federal income taxation and all the dishonorable tax sheltering gimmicks and lobbying of Congress to create special interest tax legislation. Special interest tax legislation has caused a dangerous rise in political factions throughout America, and has led our nation to become politically disunited. By establishing a *fixed rule for direct taxation,*there is no allowance for political disunity to be bred through the creation of tax loopholes and special interest tax sheltering gimmicks, created by Congress. This will help to bring the States closer together to solve Americas' real social and economic problems, and reduce political disunity bred among the people by Congress.

RELIGIOUS LIBERTY PRESERVED BY STATE RATE TAX

In view of the alarming development recently occuring in our nation, by which the power of taxation has been blatantly used to *control and regulate into extinction a number of small fundamentalist churches and their schools,* the State Rate Tax will come as a blessing to our nations' religious community; *it will preserve their religious freedom guaranteed by the First Amendment of our Constitution, and shield the Amendment from being weakened under the cloak of raising revenue.*

STATE LEGISLATURES BEST JUDGES IN RAISING DIRECT TAX

There is no question as to a states' legislature being the best judge as to the mode of raising a federally imposed direct tax. The State Legislature being closer to the people, is better informed to disburse such a burden in an equitable manner, taking into account unique geographical and economic circumstances, and moulding taxation accordingly. The State Rate Tax allows each State to be its own judge in deciding how its share of this federal burden shall be raised, and will protect all people, rich and poor alike, from the costs of the federal government being raised and collected by Congress in an unjust, arbitrary manner; it puts the control of such an important and personal matter into the hands of the peoples local representatives who must meet this obligation.

Under this plan a balance is achieved in which equitable taxation will be the final result. If a state government should impose inequitable taxation, even if it is only resorted to when raising a states' share of the apportioned direct tax imposed by Congress, and the state government insists on distributing its burden selectively upon the States' productive citizens or its small businesses at rates which become intolerable, these citizens, or small businesses, are able to flee from such taxation to states whose administrations respect the productive members of society, and which offer equitable systems of raising revenue.

The freedom of a states' business community to flee oppressive taxation is an important check and balance to prevent the power of taxation being used to destroy. As it is now practiced, productive citizens have no where to flee to escape federal taxation, and so, Congress is left to engage in mischief and manipulate taxation so as to seek out hard working wage earners, or small businesses, asking them to pay a disproportionate burden of federal expenditures, regardless of where they may live.

OPPOSITION TO THE STATE RATE TAX

Those in opposition to the State Rate Tax claim the system would place an unfair tax burden upon those states having the greatest voting strength in Congress. The fact is, the State Rate Tax *is not to be imposed except upon dire emergency as previously outlined, and indirect taxes are to be Congress' primary source of revenue.* However, the states having the larger voting strength in Congress, and required to pay a proportionate share of this direct tax based upon their larger voting strength, will also have a greater say in the policies Congress adopts, and a larger population to absorb their burden if the State Rate Tax is imposed.

By matching each states' share of the direct tax to its voting strength, no state can use its voting strength to increase the burden of taxation upon other states without also increasing its own burden of taxation in a similar fashion! Thus, the voting strength of each state can in no way be used as an economic advantage when the State Rate Tax is invoked; each state pays according to its voting strength as required by Article 1, Section 2, Clause 3; Article 1, Section 9, Clause 4 of the United State Constitution, and *this was the intention of our Founding Fathers.*

IN CONCLUSION

Congress has never been granted a blanket power or unlimited power to tax the people. Congress has no power to directly tax one, for the benefit of another, a violation of voluntary association; nor a power to be benevolent at home or abroad at the expense of the American citizen through a tax on his money or other property. Congress may not tax to spend as it pleases, for whatever whim it may entertain. Our Founding Fathers gave us a free country and meant for us to remain free, and gave us the tools with which to keep us free. The tools of the Constitution and the checks and balances it provides are to protect the sovereignty of the Citizen.

There has never been a grant of power from the people to the Congress to tax the people of the United States. The State Rate Tax is the Constitutionally provided limited power of direct taxation permitted to Congress by the will of the people. And, we will continue to suffer as a nation until we demand our Constitution be followed.

The Constitutional Authority of Taxation Granted to the Congress

Art. 1, Sec. 2, Cl. 3 & Art. 1, Sec. 9, Cl. 4.

DIRECT TAXES

Involuntary—cannot be avoided
Subject to/Rule of Apportionment according to Congressional Representation.
Tax bill sent to each State.
Maryland's share = 1.83% of sum certain.
To be used in emergency only, to prevent deficit spending.
To reduce a war debt.
No power to tax the people of the United States.

Art. 1, Sec. 8, Cl. 1

INDIRECT TAXES

Voluntary—can be avoided
Subject to/Rule of uniformity; geographic uniformity only is required.

(PRIVILEGES)			(EXCISES)	
Corporate Charter	License to practice Law	Customs Duties	Illegal profits or gains.	Mfr, sale, use tax on articles of consumption.

All of the above categories demonstrate that the subjects, objects, or items of taxation are inanimate objects and therefore there is no grant of power or authority to the Congress of the United States to tax the people of the United States.

Since the Constitution of the United States provides for only two classes of taxation, Direct and Indirect, with direct taxes to be laid only upon the States and indirect taxes to be laid only upon inanimate objects it is proven that the Congress has not been given any Constitutional authority to tax the people of the United States.

The restrictions upon the taxing authority of the Congress do not prohibit any individual from volunteering to become a taxpayer and to make oneself subject to the authority of the IRS by the filing of a 1040 form. The filing of a 1040 makes you subject to the authority of the IRS even though you may not owe any money to the government following their formula to determine the existence of any profit or gain. (Have a tax liability.)

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12-[illegible] March 26, 1984

22 March
Congratulations! Excellent article.
Lowell

Balanced Budget In Constitution

EXCLUSIVE TO THE SPOTLIGHT

By Trisha Katson

The U.S. Constitution mandates that the budget be balanced. Thus, the Constitution does not need to be amended to provide a balanced budget.

With a federal deficit of about $200 billion expected again this year, the national debt mounting and a Congress unwilling to change its free-spending ways, numerous remedies have been proposed.

These include various Constitutional amendments to balance the budget and an array of inventive ways to increase your taxes. For good measure, various ways to cut spending have even been offered.

But in the quest for a new solution to the serious economic problems that now relegate a bankrupt United States to debtor nation status, few have bothered to turn to our existing Constitution.

REVOLUTIONARY FORMULA

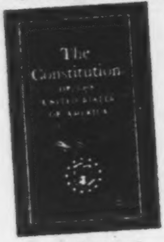
Our Founding Fathers had designed a revolutionary and equitable concept of taxation that when implemented furnished perfect checks and balances between the federal and state governments and discouraged deficit spending by Congress.

If this Constitutional formula had been observed as our forefathers intended, our nation would not be encumbered with a national debt of $12 trillion (counting unfunded liability) and the fiscal nightmares we now suffer.

If you are not familiar with the method our forefathers designed to balance the budget and assure prosperity, you are not alone. The vast majority of lawyers, tax attorneys, accountants, and even those who envision themselves as "Constitutional scholars," are unacquainted with this formula because it is not taught in public schools, colleges or even law schools.

Fortunately for all patriotic Americans who are seeking the answer to reform the fiscal policies of our government, two dedicated populists have discovered it.

Edward A. Ellison Jr. and John William Kurowski spend a great deal of their time educating Americans about this Constitutional formula to balance the budget. They eschew accolades for themselves and are quick to point out that the message they seek to deliver to the people is not their own but that of our forefathers. Kurowski describes himself and his colleagues simply as "ordinary citizens, just trying to restore our republican form of government."



See special offer on page 6.

To this end, they travel around the country, making appearances on TV and radio talk shows; they speak at public gatherings and contact any parties they believe should take an interest in the achievement of a balanced federal budget.

GIMMICK

Mindful of the attitude on the part of some people that the Constitution is an "antiquated" document, Ellison and Kurowski use a gimmick of sorts to promote the forefathers' formula. They call the proposal the "state rate tax" (SPOTLIGHT, Dec. 12, 1983) and initially present it as if it were a new idea. After they have explained the concept to interested parties, they then explain that this is no new solution, that it comes right out of the Constitution, and that they are only expounding on the formula invented by our Founding Fathers.

Here is the formula now embodied in the Constitution (which the president, Congress, state legislators, and all federal and state executive and judicial officers are bound by oath to uphold):

Congress has been granted the Constitutional authority to apply taxation in two basic forms:

- Direct taxes, which are involuntary. These are subject to the rule of apportionment according to congressional representation (Art. 1, Secs. 2 and 9 of the Constitution).
- Indirect taxes, which are voluntary. These are subject to the rule of geographic uniformity (Art. 1, Sec. 8).

Direct taxes are raised by state legislatures, which take their own unique geographical and economic circumstances into account when deciding on the manner in which to impose them. These taxes are to be used only in emergencies or to prevent deficit spending or to reduce a war debt.

Indirect taxes are raised by the federal government in the form of excises placed on articles of consumption; on income earned under government-granted licenses; and on income earned through a specific privilege which government has been delegated power to authorize.

Indirect taxes are also provided by imposts and duties.

NO TAX ON PEOPLE

As neither indirect nor direct taxes are placed on people but on inanimate objects or on privileges granted to individuals by the government, it is clear that Congress has never been given any Constitutional authority to tax the people of the United States.

With the state rate tax, the federal government first collects the revenues it needs to pay for its outlays through indirect taxation. Article 1, Section 8 lists authorized objectives of the federal government to be met through indirect taxation. If the federal government does not recover adequate revenues through indirect taxation, then each state is sent a bill for the remaining amount, according to the representation the state has in the House of Representatives.

John Kurowski (left) and Ed Ellison, who live and work in Maryland, have been studying the Constitution and the intent of our Founding Fathers for the last five and 10 years, respectively. They are engaged in a grass-roots drive to tell the people about how the state rate tax—our forefathers' formula, as outlined in the Constitution—will balance the budget.

Congress would not engage in deficit spending and borrow with interest from the Federal Reserve to cover the difference, as is today's practice.

California, with 45 representatives in the House, would pay 45 times as much as Delaware, which has only one representative.

If the federal government had collected more revenues through indirect taxation than it needed to pay for its outlays within a fiscal year (it seems unlikely now, but this has happened in our history), this would result in a surplus, which would be refunded to each state according to its representation.

Since it is unlikely that many states would relish being forced to pick up the tab for whatever spending the central government is unable to pay for, Congress is going to exercise fiscal restraints it never thought it had.

Congress would be less likely to authorize giveaways to foreign countries; bail out the international bankers; subsidize failing industries; provide handouts to able-bodied yet non-producing members of society; or pander to every special interest group imaginable.

CANCEL DEBTS

If Congress continued its present practice and disobeyed the Constitutional command that all debts be extinguished each fiscal year, then the state legislatures, knowing that these debts could be apportioned among themselves at any time, would keep the pressure on Congress to cancel these debts.

If state legislators allowed Congress's spending to go unchecked, an unlimited amount of direct taxes might then have to be paid by their constituents and these state legislators would soon find themselves without jobs.

As Kurowski notes: "The people are closer to their state legislators than they are to their congressional delegation. It's a longer walk from, say, California to Washington for angry constituents armed with tar and feathers than it is to their state capital."

This is the "state rate tax" and it is the ideal solution to stop deficit spending by Congress.

The proposals before Congress and endorsed by the administration to provide for a Constitutional amendment to balance the budget are fraudulent but politically expedient devices employed in this election year (SPOTLIGHT, March 19).

The balanced budget/tax limitation amendments receiving the most support among congressmen do not make a balanced budget mandatory. These bills allow the federal government to keep borrowing from the bankers. They provide no method to repay our national debt and do not limit the rate of tax increases.

PROSPERITY

In their booklet "Prosperity Restored by the State Rate Tax," Ellison and Kurowski note: "Our Founding Fathers gave us a free country and meant for us to remain free and gave us the tools with which to keep us free. The tools of the Constitution and the checks and balances it provides are to protect the sovereignty of the citizen."

Our forefathers' formula has not been followed in many years. The last time it was used was in 1861.

It is up to concerned citizens to educate their neighbors and their state legislators about the state rate tax and to demand that their congressmen obey the commands of the Constitution, which they are sworn to uphold.

For more about the state rate tax, contact: Free State Constitutionists, 6909 York Road, Baltimore, Maryland 21239. ❡

Senator **Chafee**. I thank all the members of the panel, and the witnesses today. This concludes our fourth day of hearings on tax reform suggestions. All the witnesses have been helpful, and we adjourn the hearing.

[Whereupon, at 11:49 a.m., the hearing was concluded.]

[By direction of the Chairman the following communications were made a part of the hearing record:]

American Farm Bureau Federation

WASHINGTON OFFICE
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AREA CODE 202 - 484-2222

September 27, 1984

Honorable Robert Dole, Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Much has been said about the need for and inevitability of tax increases to reduce the deficit. Farm Bureau disagrees. We believe that deficits and high interest rates are symptoms, not the cause, of the nation's financial problems. Rather, the growth of the federal government, particularly in entitlement programs, has caused most of the economic problems that the country has experienced within the past quarter century. If Congress looks toward tax increases to balance the budget and reduce deficits, we believe that its goal will not be achieved. More tax revenues provide only greater opportunity for the federal government to continue its fundamental problem: overspending. Higher taxes will not balance the budget.

The Committee has been conducting hearings on fundamental tax reform and the deficit. The American Farm Bureau Federation, which represents over 3 million member families throughout 48 states and Puerto Rico, offers these comments to the committee for inclusion in the hearing record.

Budget Policy: Freeze

Farm Bureau believes that the country needs to embark upon a freeze-and-fix plan, a program to freeze cost-of-living-adjustments in federal entitlement programs for a three-year period during which the necessary reform in the programs would be accomplished. Federal spending should be frozen at the previous year's appropriations level with the exception of interest payments and adequate defense funding.

Tax Policy: Encourage Investment and Economic Growth

Farm Bureau's tax and economic policies are attached for your information. These policies were developed by individual farmers and ranchers at county Farm Bureau meetings throughout the country. In summary, you will find that these recommendations state that the federal government should balance the budget through spending reductions, not tax increases. We consider a freeze on currently scheduled tax cuts to be a tax increase because a temporary freeze all too often becomes permanent. Farmers support constitutional amendments to balance the budget and to provide for a Presidential line-item veto. Tax policy should encourage private initiative and economic growth. Tax indexing should be preserved to fight bracket creep stemming from inflation. Tax proposals such as the flat tax should be studied to consider the effects upon farmers and ranchers. A value added tax should be opposed because it could adversely affect exports of farm products at a time when we need all the markets we can get. Capital gains treatment should encourage investment without creating loopholes. Tax reform to abolish loopholes should be considered to provide equity for all taxpayers.

Speaking of equity, we believe that Congress should take steps to erase the inequity that currently exists in the tax treatment of health insurance coverage. The inequity exists between self-employed people who must purchase their own health insurance without the benefit of any tax deduction and employees who received employer financed health care coverage as a tax-free fringe benefit. Farm Bureau has embarked upon a nationwide grassroots effort to gain support for S. 2353 (Grassley; R-Iowa) and H.R. 3487 (Latta; R-Ohio). These bills would provide a business deduction for self-employed people who purchase their own health insurance coverage. We believe that a deduction for one half of the health insurance premium is an appropriate way to correct the inequity rather than taxing the fringe benefit of other employees. Farm Bureau submitted comments on S. 2353 (H.R. 3487) to the Senate Finance Subcommittee on Taxation and Debt Management in July. The statement is attached for your use.

We encourage you and your staff to review these policies and call upon Farm Bureau if we can provide you with any other information.

Sincerely,

Robt. B. Delano

Robert B. Delano
President

RD/ilm
Attachments
cc: Committee Members

Monetary and Fiscal Policies

"Farm Bureau strongly supports the continued reduction in the size of the federal government to stop inflation and increase productivity. This is our top priority. Balancing the federal budget will not be possible unless there are further substantial cuts in federal spending.

"Farm Bureau supports an across-the-board freeze on all federal spending at the previous year's total appropriations level with the exception of interest payments on the national debt and an adequate defense. This freeze and spending limitation shall take priority over all other federal spending policies adopted by Farm Bureau.

"Farm Bureau supports a freeze-and-fix program to reform all federal entitlement programs. The plan would require a three-year freeze, or moratorium (no increase), in all federal cost-of-living adjustments. If Congress does not fundamentally fix the entitlement programs within the three-year period, the freeze would continue until Congress accomplishes necessary reforms.

"We support legislative or constitutional changes to give the President line-item veto power in appropriations bills.

"We support a constitutional amendment to require the federal government to operate on a balanced budget each year. Only in extreme emergencies could this requirement be waived with the concurrence of the legislative and executive branches of government. A balanced budget should not be achieved by levying new taxes or increasing tax rates.

"We support a constitutional amendment to restrict the spending authority of the federal government to a realistic percentage of the gross national product (GNP).

"Off-budget federal outlays, including federal credit programs, should be brought on-budget as direct federal outlays. The Federal Financing Bank should be abolished.

"The goal of monetary policy should be general price level stability. The Federal Reserve System should conduct a sustained, long-term monetary policy which will minimize inflation and deflation of prices. Should the Federal Reserve System fail to maintain sound discretionary monetary policies, we will support legislation to instruct the Federal Reserve System to achieve a specified rate of growth in the stock of money consistent with real economic growth, productivity and general price level stability. The Congress of the United States should conduct an audit and special public hearings on the Federal Reserve System.

"Recognizing that a significant portion of federal spending is incurred through government contracts, competitive bidding should be encouraged. The use of "cost-plus" contracts should be minimized."

Income Taxes

"Tax policy should be designed to encourage private initiative and economic growth.

"We support income tax indexing.

"We oppose a freeze or cap on scheduled tax cuts.

"When income tax cuts are considered, reductions in tax rates are preferable to changes in the tax laws which reduce the number of taxpayers. We recommend that any tax cut be accompanied by a comparable cut in government spending.

"Farm Bureau should closely monitor "flat rate" tax proposals to determine the feasibility and desirability of adopting this concept of income taxation and provide information on the flat rate tax to the state Farm Bureaus.

"Internal Revenue Service investigative procedures should ensure that individuals are made aware of their rights and are notified of proposed actions prior to any action which might infringe on those rights.

"We support legislation to preserve the confidentiality of federal income tax returns and to prohibit access to them and the use of information from them for any purpose unless such action is authorized by an appropriate court order.

"Taxpayers should be given the option to treat investment in capital equipment for the abatement of air, water and soil pollution as a current expense for federal income tax purposes since such investments generally increase costs without increasing production.

"Additional tax credits should be provided to industries which are required to comply with OSHA regulations, including standards more stringent than those adopted at the federal level.

"Since many taxpayers receive employer-financed hospital and medical insurance as a tax-free benefit, we recommend that other taxpayers be permitted an income tax deduction or credit for the cost of their health insurance premiums.

"We favor continuation of the current tax-exempt status of the interest on state and local bonds.

"We support an income tax credit for the parents of students enrolled in post-secondary education.

"We recommend that changes be made in the income tax laws to allow farmers who have incurred losses due to declared natural disasters to be allowed to apply for the carry forward provisions of the internal revenue code until the loss is completely written off within a maximum of 10 years.

"We oppose efforts to require farm employers to withhold income taxes from farm workers' earnings.

"We oppose the taxing of interest income as it accrues. We recommend that, to encourage savings, the federal tax exclusion for interest and dividends be increased to $1,000 for individual returns or $2,000 for a joint return.

"We believe farmers should continue to be able to select either the cash or accrual method of filing income tax returns.

"The alternative minimum tax provisions of the Internal Revenue Code can result in a higher income taxes for farmers who have capital gains. This tax cannot be reduced by the investment tax credit. We support the repeal of the alternative minimum tax provisions.

"We support repeal of the requirement for farmers to file 1099 forms; otherwise, seek to increase the reporting level from $600 to $5,000.

"We oppose the use of agricultural land as a long-term, tax-sheltered investment by pension and profit-sharing funds.

"We urge that the Internal Revenue Service abide by the decisions of state and local officials as to which agricultural lands shall be preserved in farm use through use of tax-deductible contributions of voluntary, private conservation easements.

"We believe the Internal Revenue Code (Sec. 163) should be amended to permit farmers and ranchers, whether on cash or accrual basis of accounting, to deduct interest payments on farm loans as an expense item whether the interest payment is made with funds obtained from the original creditor through a second loan, an advance or other financial arrangement similar to a loan or from funds secured from a second creditor."

New Federalism

"We will support the shifting of additional responsibilities from the federal government to state governments if at the same time adequate access is made to the tax structure to allow for the financing of such programs by the states and a commensurate reduction is made in federal taxes."

+ +

Independent Contractor Status

"During the last several years the Internal Revenue Service has attempted to change several taxpayer classifications from independent contractor to employee. This group includes custom harvesters, carpenters, truck drivers, insurance agents, realtors, and other individuals traditionally considered independent contractors. We recommend that the present independent contractor status of the affected individuals be preserved."

+ +

Investment Credit

"Farm Bureau favors maintaining the permanent status of the investment tax credit. We should work to secure the investment credit on facilities used in agricultural production.

"We favor allowing investment credit on qualified used assets purchased by a lineal descendant but not on property that is repurchased by the previous owner.

"We support an amendment to the Internal Revenue Code to provide an investment tax credit for horses used for breeding and working purposes."

Capital Gains

"The tax treatment of capital gains should encourage investment without creating tax loopholes or discouraging the sale of property. The present law results in the taxation of "gains" which reflect, in part, a decline in the value of the dollar. We favor retention of the present minimum holding period.

"We support an exemption from the capital gains tax when a farm is sold and another farm purchased within 18 months after the original sale.

"When farmers are forced by government regulation or condemnation to sell land, buildings, livestock or other production items, they should be exempt from tax on the proceeds from such sale, provided they have owned the farm for five or more years and have derived at least half their income from farming for at least five years. Property owners affected by eminent domain should be given the option of replacing the condemned property or reporting the taxable gain over a period of years.

"We oppose proposals to apply the capital gains tax to the appreciated value of property transferred by reason of the death of the owner.

"We support the present law with respect to capital gains treatment for sales of breeding livestock and forestry products.

"We favor legislation that would reduce capital gains taxes for retiring farmers who sell their farms to farmers and finance the farms themselves."

+ +

Federal Estate Taxes

"We favor repeal of the federal estate tax. Pending repeal, federal estate tax exemptions or credits subsequent to 1987 should be indexed by the change in the Consumer Price Index.

"We oppose efforts to freeze scheduled increases in estate tax credits (exemptions) before they become fully effective.

"We oppose tax law or Internal Revenue Service regulations that provide for the recapture of estate tax benefits under special use valuation when heirs conduct necessary husbandry practices in their timber stands.

"We will support legislation to permit a full "credit for state death taxes" in determining federal estate tax liability where state death taxes are paid in installments."

Sales and Excise Taxes

"The retail sales tax should be reserved to state and local governments.

"Federal excise taxes should be limited to:

"(1) Nonessentials; and

"(2) User taxes, such as the tax on passenger transportation by air and taxes committed to the federal Highway Trust Fund.

"We support the exemption of agricultural aircraft fuel from the federal airport and airway taxes. We oppose the use of funds collected as taxes on aircraft fuels for purposes other than improvement of the nation's airways.

"We oppose any additional tax on any farm commodity.

"We oppose the adoption of a federal value-added tax.

"We recommend that the excise tax on sales of well head oil be removed. Until this is accomplished, we support an exemption of 10 barrels of production per day for the royalty owner."

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SENATE COMMITTEE ON FINANCE REGARDING TAX DEDUCTIBILITY OF HEALTH INSURANCE PREMIUMS FOR THE SELF-EMPLOYED

July 23, 1984

The American Farm Bureau Federation is pleased that the Subcommittee is holding hearings on tax policy issues surrounding fringe benefits. We note that the Subcommittee will be examining a number of questions including: "Are the existing rules concerning fringe benefits sufficient to ensure that all employees benefit fairly from the tax incentives?"

To assist the Subcommittee in developing "a full, fair hearing record on current fringe benefit topics" we have modified the question to reflect our concern about the equity of current tax treatment of health insurance premiums for the self-employed. This is an important issue for the nation's farmers and ranchers, most of whom are self-employed sole proprietors.

No group is more aware of the financial grip of high health insurance premiums than self-employed individuals, particularly farmers. Together with employees who do not receive employer-financed health insurance as a fringe benefit, the nation's 7.8 million self-employed business people must confront the serious inequity that exists in the use of income tax deductions to subsidize health insurance for other groups of workers.

While the Internal Revenue Code permits an employer to deduct employee health insurance premiums as a business expense (IRC 162) and treats the premiums as a tax-free fringe benefit to the employees (IRC 106), this type of tax treatment is not available to the self-employed worker. The self-employed person gets no deduction, but must buy health insurance with after-tax dollars. Currently, the only way a self-employed individual can deduct any amount of health insurance costs is if the premium is included in an aggregate of itemized medical expenses constituting more than 5 percent of adjusted gross income (IRC 213).

The denial of a deduction is apparently because health insurance is considered a personal expense rather than a business expense. Farmers and ranchers disagree with this short-sighted reasoning. Farmers, like other small business people, conduct business activities common to both employers and employees. The work environment of a farmer is often hazardous and not infrequently presents danger to life and limb from the use of heavy equipment and chemicals. Insurance is necessary to cover the costs of unexpected injury and illness stemming from the farming occupation. Health insurance is a cost of doing business that farmers as business owners cannot afford to be without. We believe it is a reasonable request that a self-employed person be able to deduct his or her insurance premium as a business expense.

There is also a question of equitable tax treatment among farmers who have different business organizations for their farming operations. A farmer who is a sole proprietor or in a partnership cannot deduct the cost of health insurance premiums as a business expense. However, if the farm is incorporated, the farmer can be classified as an employee of the farming corporation. The corporation, as the employer, can deduct the cost of health insurance as a business expense, and the farmer, as the employee, can receive the health insurance tax-free.

The vast majority of farms in this country are operated as sole proprietorships. The 1978 Census of Agriculture indicated that 88 percent of all farms with sales of $2,500 or more were sole proprietorships, 10 percent were organized as partnerships, and 2 percent were incorporated. These figures translate into approximately 2.14 million sole proprietorships operated by farmers.

The Subcommittee will be interested in the amount of health insurance premiums that farmers pay. In Iowa the 1983 monthly cost of comprehensive major medical group plan insurance with no deductible was $84.15 for a single person and $185.27 for a family. This equals $1,010 and $2,223 on an annual basis. In Michigan where age ratings apply, the annual family rate premium ($0 deductible) was $2,120 for insureds under age 45. The annual cost jumped to $3,150 for those between 45-54 and to $3,474 between 55-64. Even plans with deductibles are expensive. For instance, the 1983 family rate in Kansas for insureds age 40-44 with a $600 deductible was $778. The 1984 family rate in Texas for insureds age 40-44 with a $2,000 deductible per person per year is $1,320.

The rates illustrate the high out-of-pocket costs that farmers pay. Remember that they take no deduction for this cost although their in-town neighbors who work for a business that provides health insurance can receive the same coverage as a tax-free fringe benefit. Also, bear in mind that the Tax Equity and Fiscal Responsibility Act eliminated the $150 deduction for health insurance premiums that all taxpayers could have applied against the cost of their health insurance premiums.

We believe that the following arguments support a legislative remedy to this problem:

EQUITY

As previously mentioned, the federal government is subsidizing health insurance for taxpayers receiving employer-financed health insurance at the expense of two other groups of taxpayers who cannot take advantage of current tax code provisions: (1) Self-employed taxpayers such as farmers and, (2) Employees who must buy their own coverage.

Even if Congress restricts the current tax-free status of employer-financed health insurance, the inequity will remain. Those employees currently receiving such benefit will continue to receive a certain level of coverage tax-free since all or a portion of the coverage will fall below the tax threshold amount of $840 per individual or $2,100 per family as proposed by the Administration.

PRECEDENT

The Social Security Act amendments of 1983 moved toward equity between employers and the self-employed in Social Security tax treatment. The new law provides that self-employed individuals will be able to take a tax credit for 1984-1989 against the self-employment tax that they must pay. After 1990, a new system of income tax deductions will be available to self-employed taxpayers. The deduction will be equal to one half of the amount of self-employment taxes paid for the taxable year.

A deduction or credit for the cost of health insurance premiums could be patterned after the credits/deductions enacted in the Social Security legislation.

RISING HEALTH CARE COSTS

Much has been said about the issue of health care insurance for the unemployed. The employed, as well as the unemployed, are hurt by rising health care costs, particularly those in hazardous occupations such as farming who may pay higher premiums because of higher risks.

HIGHER TAXES COMPOUND CASH FLOW PROBLEMS FOR FARMERS -- HEALTH INSURANCE DEDUCTION COULD HELP EASE THE PROBLEM

Farmers have been hit recently with higher Social Security taxes, gasoline taxes, and excise taxes. An appropriate health insurance premium deduction would ease the increasing tax burden on self-employed people, help compensate for direct, out-of-pocket expenses for health insurance, and lead to more equitable tax treatment of health care coverage.

We draw the Subcommittee's attention to two bills, H.R. 3487 (Latta; R, Ohio) and S. 2353 (Grassley; R, Iowa), that would allow the self-employed to deduct one half of health insurance premiums as a business expense. Farm Bureau members across the country are working hard to gather support for these bills as well as other legislation that would eliminate the inequity that exists in the tax treatment of health care insurance. As of mid-July, H.R. 3487 had 136 co-sponsors and the Senate bill had seven co-sponsors. We believe that this legislation is a fair and reasonable response to provide equity for self-employed individuals.

On behalf of 3.3 million Farm Bureau member families, we ask you and the Subcommittee members to lend your support to this legislation.

AtlanticRichfieldCompany
Employee Relations
515 South Flower Street
Los Angeles, California 90071
Telephone 213 486 1754

D. H. Smith
Senior Vice President

September 24, 1984

Mr. Roderick DeArment
Chief Counsel
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. DeArment:

Enclosed is our submission to the Congressional Hearing Record for the Senate Finance Committee hearings on major tax reform September 11 and 20, 1984.

Very truly yours,

DHSmith

D.H.Smith

DHS/mll
Enclosures

SUBMISSION ON TAXATION OF EMPLOYEE BENEFITS

UNITED STATES SENATE
COMMITTEE ON FINANCE

HEARINGS ON MAJOR TAX REFORM
SEPTEMBER 11 AND 20, 1984

BY

DWAINE H. SMITH
SENIOR VICE PRESIDENT
EMPLOYEE RELATIONS
ATLANTIC RICHFIELD COMPANY

My name is Dwaine Smith and I am Senior Vice President, Employee Relations, of Atlantic Richfield Company. My Company is a diversified resource company and is among the twelve largest industrial corporations in the United States. It sponsors a comprehensive package of employee benefits that provides a "safety net" of protection against economic hazards to employees. Most of the employee benefit plans that are offered are made possible only because of enabling provisions in the Internal Revenue Code. These tax favored provisions allow employees, particularly lower and middle income employees, to build upon the basic level of protection afforded by Social Security and Medicare. We believe very strongly that tax preferences for welfare benefit plans and pension plans are critical in achieving broad employee participation in these programs. Our experience with the implementation of a Section 401(k) CODA Plan provides ample evidence that employee participation significantly increases with increased tax benefits. The abolition of these preferences will very likely cause employees to elect significantly reduced coverages, expecially for those employees at lower income levels. In addition, since defined benefit and defined contribution plans constitute the major source of savings for middle and lower income employees, the restriction or elimination of tax preferences for these plans will have a significantly detrimental effect on the already low rate of personal savings. Because we believe that employee benefits serve useful social needs, I am submitting for the record Atlantic Richfield Company's position on tax policy and its effect on employee benefits. The submission focuses on my Company only and is structured as follows.

(1) Level of Tax Exempt/Tax Deferred Employee Benefits
(2) Cap on Tax Favored Benefits
(3) Treatment of Tax Deferred vs. Tax Exempt Benefits
(4) Relationship Between Private Pensions, Social Security and IRAs
(5) Private Health Care Plans and Medicare
(6) Tax Treatment of Fringe Benefits
(7) Income Level of Employees Who Utilize Benefits
(8) Effect on Employee Benefits if "Tax Reform" Proposals Adopted
(9) Maintaining a Viable FICA Tax Base

(1) Appropriate Level of Tax Exempt/Tax Deferred Employee Benefits

Our tax **deferred** benefits are paid from the Atlantic Richfield Retirement Plan (ARRP), the Savings Plan, a Capital Accumulation Plan (CAP), and a payroll based Stock Ownership Plan. The **tax-exempt** benefits are paid primarily from the Medical Plan, the Dental Plan, the Life Insurance Plan (up to the IRC. Sec. 79 maximum), and partially, from the Long Term Disability Plan. In addition, employees have the option, like other taxpayers, to open personal IRAs. Thus, employees are given ample opportunity to accumulate, on a tax favored basis, savings for both short term and long term needs. Given the combination of large federal deficits, and the fact that IRA deposits result largely from a **shift** of other savings rather than net new savings, Congress may want to re-examine the tax favored status of IRAs for those individuals also covered by employer sponsored plans. As for tax-exempt benefits, we submit that the majority of employers are already deeply concerned about increasing employee benefit costs, particularly health care costs, and are taking steps to contain these costs. For example, Atlantic Richfield Company has done the following:

(i) Taken a very conservative position on the creation of new employee benefit programs.

(ii) Designed our Capital Accumulation Program with an economic incentive for employees to participate, causing the generation of significant long term personal savings to be available only at termination or retirement. Over time, this will allow the Company to phase out our supplementary retirement program. (This plan grants periodic ad hoc retirement supplements to compensate retirees for the erosion of retirement income due to inflation.)

(iii) Redesigned our medical plan to contain the rate of increase in health care costs. Specifically:

- Employees have been given a choice between an older, established "first dollar" plan or a newly adopted (1984) comprehensive plan that requires a greater amount of cost sharing on the part of the employee. The former costs the employee substantially more in monthly contributions, while the latter requires plan users to assume a greater share of the costs.
- Employees are offered a selection of Health Maintenance Organizations (HMOs) in a more liberal manner than required by law.
- The Company is active in employer coalitions in Los Angeles, Philadelphia and Houston. A Company executive chaired the Los Angeles Coalition in 1981-1982.
- We have initiated a pilot program of utilization review in California.
- We have implemented, and are refining, a sophisticated claims data base system that pinpoints areas of over-utilization.

(2) Cap on Tax Favored Benefits

A tax cap could be either a percentage of compensation or a dollar limit. The obvious problem with any cap is to determine its appropriate level. If the cap is denominated in dollars, there is the immediate disparity accorded identical groups of employees situated in different areas of the country. Furthermore, in inflationary times, the dollar limit may not be increased in a timely fashion to reflect adequately the increased price level. The problem with a percentage of compensation cap is its very arbitrariness - lower paid employees may not be able to gain the maximum coverage of fixed cost benefits, while higher paid employees may often obtain the benefit and still have an excess available. In addition, those employers with older more highly compensated workers could be competitively disadvantaged as compared to employers with younger workers. If Congress feels caps are the best alternative, our preference would be for a percentage of compensation set at a level between thirty and forty percent, excluding legally required employer contributions from the base subject to the cap.

(3) Treatment of Tax Deferred vs. Tax Exempt Benefits

Employee benefits occupy a unique tax favored status in the Internal Revenue Code. Employer contributions to tax qualified plans are deductible to the employer, earnings thereon are tax exempt, and there is no concurrent recognition as income by employees. When subsequently distributed, these monies often enjoy tax favored treatment such as ten year forward averaging and capital gains, or further deferral because of the rollover provisions in the Code. Perhaps Congress should study this area comprehensively and examine the integration of personal savings with the Social Security benefit. The significant increases in personal savings generated by IRAs and Sec. 401(k) plans should reduce future pressure on the Social Security system. Any decision to limit these plans, should not be taken lightly. The treatment of tax exempt benefits is a little more complex. Employer provided health insurance indirectly provides a form of living expense to employees in a tax subsidized manner. The same can be said for the provision of child care expenses. Both of these benefits, however, probably produce significant social benefit. Tax subsidized child care makes it easier for larger numbers of individuals to be wage earners and taxpayers. Tax benefited health insurance maintains medical coverage at a significantly higher level than would be the case if individually purchased and provides the majority of Americans with the best health care in the world. Moreover, tinkering with the tax favored status of this employee benefit may have the unintended effect of reducing care and increasing the incidence, severity, and impact of disease, especially for the lower paid segments of the population. Exhibit I attached shows the percentage of compensation that the Company's contributions to the Atlantic Richfield Medical Plan represent. A review of this exhibit shows that taxing such contributions will be highly regressive for the lower paid employees. It appears therefore, that in the area of tax exempt benefits, the best approach might well be to continue the present statutory treatment of existing employee benefits, and restrict the creation of new benefits.

(4) Relationship between Private Pensions, Social Security, and IRAs

Much has been written about the three legged stool of retirement income security provided by Social Security, private pensions, and individual savings. We present in Exhibit II certain statistics relating to pre-retirement income replacement ratios of our employees. (Missing from these statistics is the component attributable to individual savings.) You will note that our retirement plan benefit combined with Social Security provides lower income employees with a proportionately higher wage replacement ratio than higher income employees. Our goal is to provide our employees with a post-retirement income that will afford them a standard of living approximating their pre-retirement standard. There is, however, an inconsistency in the taxation of this benefit. If the retirement benefit from the ARRP is taken as a lump sum benefit it receives favorable tax treatment. In addition, the presence of favorable taxation of lump sum benefits puts pressure on employers to provide this form of payout even if society interests might be better served by payouts spread over retirement years and taxed as ordinary income. As previously indicated, the intergration of these plans with Social Security and their tax status on payout merits further examination.

(5) Relationship between Private Health Care Plans and Medicare

Our Company's philosophy in designing health care plans is to provide a reasonable level of protection to our active employees and retired employees not eligible for Medicare, in as cost-efficient a manner as possible. We believe that by keeping employees healthy, the effect is to reduce long term demands and costs associated with the medical care system. Retired employees eligible for Medicare are provided a level of protection that supplements the Medicare coverage. The partnership between private health care plans and Medicare can and should be strengthened. As the largest single purchaser of health care services in the country, Medicare has a very important role to play in helping the private sector provide appropriate health care services in a cost efficient manner. It can contribute to this area by careful screening of new medical technology before permitting Medicare reimbursement for the use of such technology. In addition, Medicare should frequently review surgical fee schedules and reduce high reimbursement levels for procedures that, while innovative when first performed, are now routine but continue to be reimbursed as if they were performed by only a few highly skilled professionals.

(6) Tax Treatment of Certain Fringe Benefits

Over the years, Congress enacted provisions in the Internal Revenue Code favoring specific employer sponsored retirement, health care plans and certain other statutory benefits, based on the premise that extensive coverage of workers and dependents under these plans is desirable social policy. These programs are a supplement to public programs and lessen pressure for increased Governmental involvement in such programs, which we believe generally deliver benefits less cost-effectively than private sector programs. These programs should continue to enjoy tax favored status. In recent years, however, certain tax advantaged benefits have been provided that do not meet a defined social objective (e.g. group legal plans.) We do not believe that this is an appropriate use of the Tax Code for social policy. It may now be appropriate to impose a freeze on the creation of new tax favored benefits. Alternatively, these programs could be removed from tax favored status or a cap set at a very low level could apply to such programs.

(7) Income Levels of Employees Who Utilize Benefits

Our Company designs our benefit programs to provide financial protection and individual and family security (alleviating problems which could reduce employees' productivity) for most of our employees. We attached a series of exhibits to this submission that show the income distribution of the participants in our employee benefit plans. It is obvious that the great bulk of benefits go to rank and file employees. The attached exhibits are:

Exhibit I	Medical Plan
Exhibit II	Retirement Program
Exhibit III	Long Term Disability Plan
Exhibit IV	Death Benefit Plan
Exhibit V	General Description of ARCO's Employee Benefit Plans

(8) Effect on Employee Benefits if Various "Tax Reform" Proposals Are Adopted

Tax Reform measures generally call for including employer contributions for employee benefits in the employee's adjusted gross income or eliminating employer deductions for such contributions. In the first case, severe problems would arise in implementation.

- Group plans are designed without allocating costs on the characteristics of the individual employee. However, if individual employees are made to pay taxes on contributions made on their behalf, then the pricing and cost allocation structure of group plans would have to be altered drastically so as to allocate an equitable "taxable/economic" value to the benefit provided the individual. In the health care area, older individuals and young women of child-bearing age would be faced with high allocations of cost to be included in their income. As we show in the attached exhibits, Company contributions represent a higher percentage of compensation for low to moderate income employees than for higher income employees. It is therefore questionable whether these individuals will purchase comparable health care coverage in the absence of tax favored group plans.

Furthermore, since health care "premiums" are derived without regard to employees' compensation, the flatter tax rates will mean that the tax treatment for lower income employees will be highly regressive.

- Defined benefit program costs are determined on aggregate bases based on demographics and investment experience. Few plans calculate costs and allocate contributions on an individual basis. However, if contributions were allocated among individuals, then clearly the older employee would face a substantial increase in imputed income. In the case of our retirement plan which has a final three year salary average formula, the cost for a sixty year old employee could be twelve times that of a thirty year old employee. Whether this would result in employees declining coverage cannot be predicted.

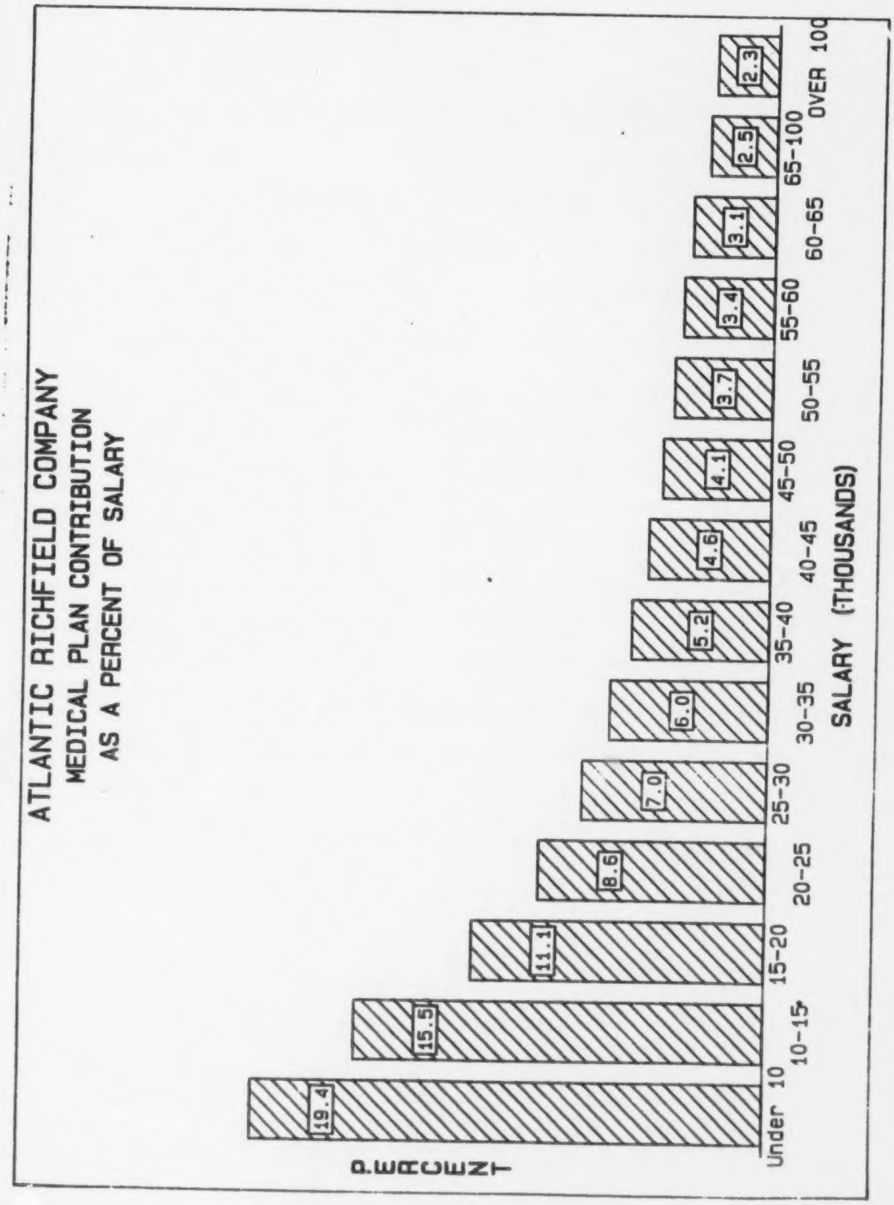
If, on the other hand, deductions for employer contributions to employee benefit plans are eliminated, the effects would be different in that many companies might well decide to scale back or eliminate employee benefit plans.

(9) Maintaining a viable FICA Tax Base

In order to maintain the viability of the FICA tax base, Congress can increase the number of participants in the system by:

- Adopting policies that will increase the aggregate level of covered employment in the economy.
- Including in the FICA program those classes of workers who are currently excluded. Expanding the level of coverage is one way to maintain the strength of the FICA system. Another way is to preclude the further erosion of the tax base by adopting measures, such as Congress took when it required 401(k) salary deferrals to be subject to FICA taxes.

EXHIBIT I



ATLANTIC RICHFIELD COMPANY
MEDICAL PLAN CONTRIBUTION
AS A PERCENT OF SALARY

EXHIBIT II

Retirement Program

The Company sponsors a number of defined benefit and defined contribution plans. The former are designed to replace, in conjunction, with Social Security, a significant percentage of employees pre-retirement income. The latter are primarily Capital Accumulation Plans, except for the Sec. 401(k) plan which is designed to provide retirement income supplements. Our experience shows that moderate income employees are not inclined to save on their own, an experience similar to other such employees across the nation. Accordingly, we designed a Savings Plan that is linked to the Sec 401(k) plan, whereby employees cannot get the benefit of the Company's matching contribution to the Savings plan unless they also contribute to the Sec. 401(k) plan. This approach is apparently successful, as almost 90% of eligible employees participate in the Savings program. In addition, the Company has a supplemental retirement program that replaces a portion of retirees income that has been lost due to inflation.

Attached are examples of replacement ratios for the Atlantic Richfield Retirement Plan (ARRP), which is the largest defined benefit plan in the Atlantic Richfield controlled group. It should be noted that the benefit formula is such that low to middle income employees **benefit proportionately more** than high income employees.

EXHIBIT II(a)

ATLANTIC RICHFIELD RETIREMENT PLAN
PRE-TAX AND POST-TAX REPLACEMENT RATIOS
JANUARY 1, 1984 RETIREMENT DATE WITH 30 YEARS OF SERVICE
MARRIED

Final Pay	AFC* 8.5% Salary Assumption	Estimated Federal & Local Taxes	Pre-Retirement Disposable Income	Social Security Benefit	ARRP Benefit	Total Benefit	Pre-Tax Benefit As a % of Final Pay	Post Retirement Estimated Federal & Local Taxes	Total Post-Tax Retirement Income	Total Post-Tax Income as % of Pre-Retirement Disposable
$ 25,000.00	$ 23,092.62	$ 5,572.27	$ 19,427.73	$13,140.00	$9,246.44	$ 22,386.44	89.55%	$ 253.89	$22,132.56	113.92%
$ 50,000.00	46,185.24	15,699.84	34,300.16	13,212.00	19,638.12	$ 32,850.12	65.70%	2,103.87	30,746.25	89.64%
$ 70,000.00	64,659.33	25,568.64	44,431.36	13,212.00	27,951.46	41,163.46	58.80%	4,684.21	36,479.26	82.10%
$100,000.00	92,370.48	41,895.00	58,105.00	13,212.00	40,421.48	53,633.48	53.63%	11,071.34	42,562.14	73.25%
$150,000.00	138,555.71	72,207.20	77,792.80	13,212.00	61,204.84	74,416.84	49.61%	20,960.69	53,456.15	68.72%

ATLANTIC RICHFIELD RETIREMENT PLAN
PRE-TAX AND POST-TAX REPLACEMENT RATIOS
JANUARY 1, 1984 RETIREMENT DATE WITH 30 YEARS OF SERVICE
SINGLE

Final Pay	AFC* 8.5% Salary Assumption	Estimated Federal & Local Taxes	Pre-Retirement Disposable Income	Social Security Benefit	ARRP Benefit	Total Benefit	Pre-Tax Benefit As a % of Final Pay	Post Retirement Estimated Federal & Local Taxes	Total Post-Tax Retirement Income	Total Post-Tax Income as % of Pre-Retirement Disposable
$ 25,000.00	$ 23,092.62	$ 6,994.60	$ 18,005.40	$ 8,760.00	$9,246.44	$ 18,006.44	72.03%	$ 808.71	$17,197.74	95.51%
$ 50,000.00	46,185.24	19,395.36	30,604.64	8,808.00	19,638.12	28,446.12	56.89%	3,259.71	25,186.41	82.30%
$ 70,000.00	64,659.33	30,632.85	39,367.15	8,808.00	27,951.46	36,759.46	52.51%	7,792.32	28,967.14	73.58%
$100,000.00	92,370.48	49,039.85	50,960.15	8,808.00	40,421.48	49,229.48	49.23%	13,594.63	35,634.85	69.93%
$150,000.00	138,555.71	80,541.15	69,458.85	8,808.00	61,204.84	70,012.84	46.68%	25,129.05	44,883.78	64.62%

*AFC: Average Final Compensation (ie. average of the last three years salary figures assuming 8.5% annual increase in compensation.)

EXHIBIT II(b)

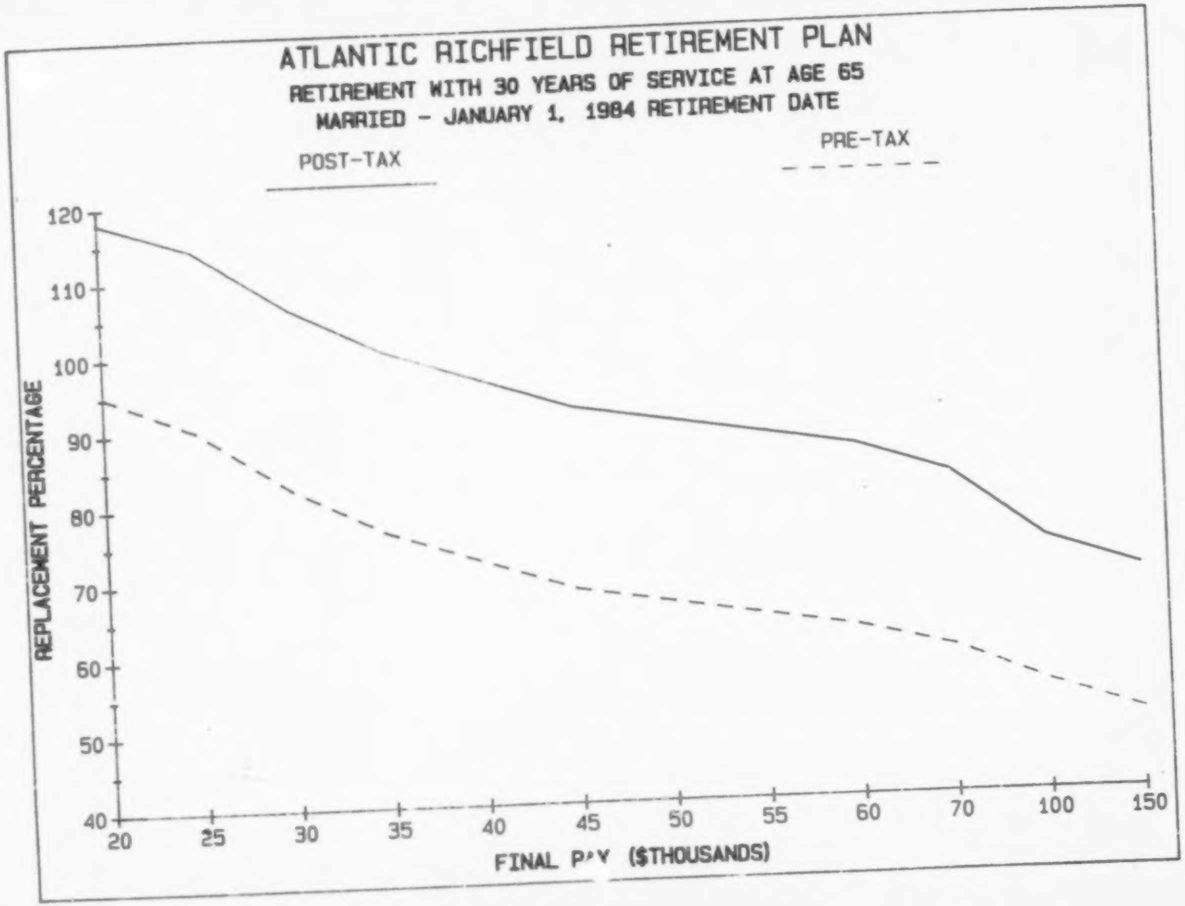

ATLANTIC RICHFIELD RETIREMENT PLAN
RETIREMENT WITH 30 YEARS OF SERVICE AT AGE 65
MARRIED - JANUARY 1, 1984 RETIREMENT DATE
POST-TAX
PRE-TAX
REPLACEMENT PERCENTAGE
120
110
100
90
80
70
60
50
40
20
25
30
35
40
45
50
55
60
70
100
150
FINAL PAY ($THOUSANDS)

EXHIBIT II (c)

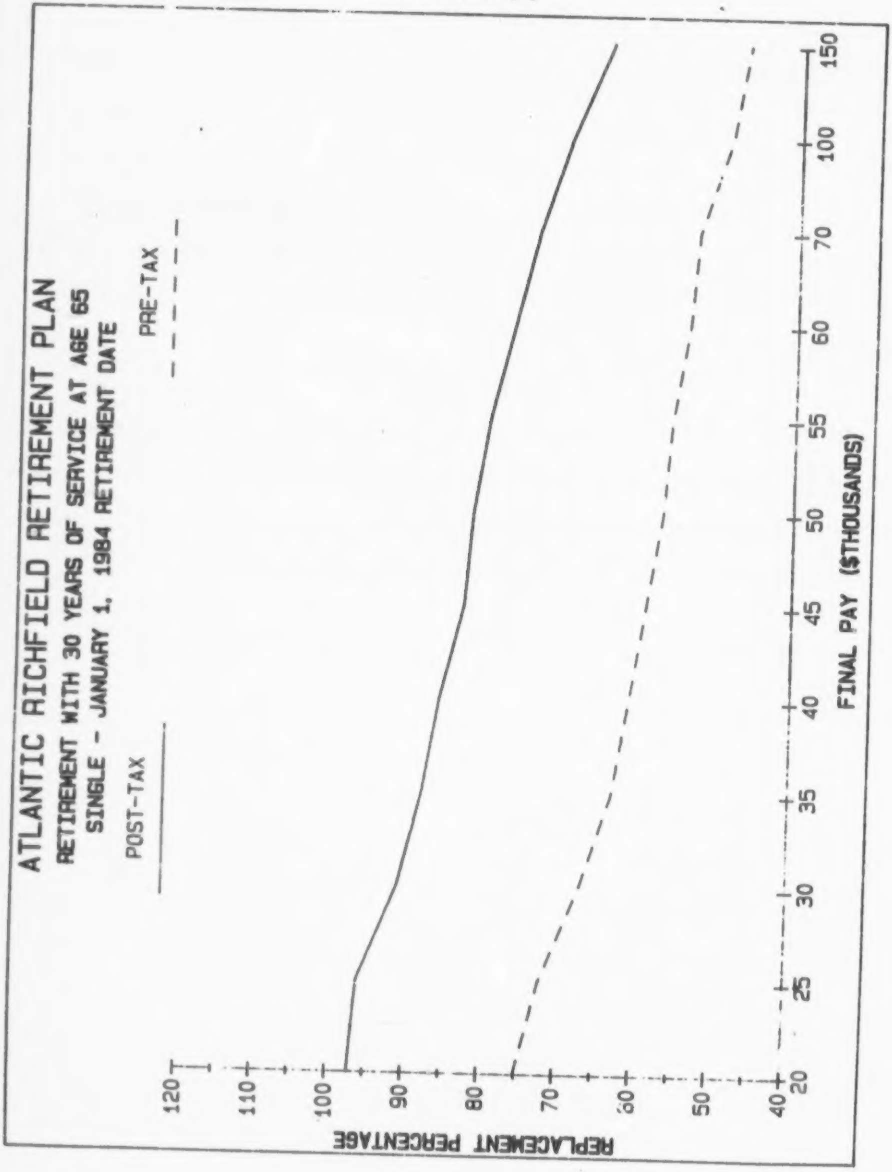

ATLANTIC RICHFIELD RETIREMENT PLAN
RETIREMENT WITH 30 YEARS OF SERVICE AT AGE 65
SINGLE - JANUARY 1, 1984 RETIREMENT DATE
POST-TAX
PRE-TAX
REPLACEMENT PERCENTAGE
120
110
100
90
80
70
60
50
40
20
25
30
35
40
45
50
55
60
70
100
150
FINAL PAY ($THOUSANDS)

EXHIBIT III

Long Term Disability

Atlantic Richfield designed the long-term disability program to replace a portion of income lost when an employee becomes permanently and totally disabled. In addition to receiving monthly payments from the Long Term Disability (LTD) plan, disabled employees continue their medical coverage on the same terms as when they were actively employed.

The attached graph shows that **91% of those receiving benefits are those employees who at the time of their disablement were earning less than $40,000.** Note that under the terms of the plan, active employees earning more than $40,000 must contribute towards the cost of the plan. In return, their benefits from the plan are higher.

EXHIBIT III (a)

ARCO LTD Replacement Ratios by Salary

	AVERAGE REPLACEMENT RATIO			
Final Salary	Ratio of LTD Plus Retirement Benefit	Social Security Only	Total	Number of LTD Cases
Under 10000	35.8%	20.9%	56.7%	6
10000 - 15000	34.7%	17.5%	52.2%	30
15000 - 20000	35.3%	22.6%	57.9%	104
20000 - 25000	34.6%	18.9%	53.5%	109
25000 - 30000	33.9%	15.9%	49.8%	83
30000 - 35000	42.1%	11.1%	53.2%	27
35000 - 40000	37.4%	11.2%	48.6%	14
40000 - 45000	49.0%	6.2%	55.2%	10
45000 - 50000	53.9%	7.0%	60.9%	8
50000 - 55000	58.4%	2.9%	61.3%	5
55000 - 60000	56.6%	7.5%	64.1%	6
60000 - 65000	55.5%	5.8%	61.3%	4
65000 - 70000	0.0%	0.0%	0.0%	0
70000 - 75000	50.5%	7.5%	58.0%	3
75000 - 80000	0.0%	0.0%	0.0%	0
80000 - 85000	60.0%	0.0%	60.0%	1
85000 - 90000	0.0%	0.0%	0.0%	0
90000 & Over	0.0%	0.0%	0.0%	0
		Total		409

EXHIBIT IV

Death Benefits

The Company generally provides active employees with life insurance protection equal to their annual salary. This is given to them at no cost. Additional amounts of life insurance can be purchased by employees at their option.

The table below shows that 64% of all settlements for the past two years were for those employees whose salary at death was $40,000 or less.

PERCENT OF ARCO DEATH CLAIMS UNDER OPTION A (ONE TIMES SALARY)

Final Salary	Total Number of Death Claims (All Options)	Number of Claims with Option A	Percent
Under 10000	0	0	0.0%
10000 - 15000	1	1	100.0%
15000 - 20000	7	5	71.4%
20000 - 25000	16	6	37.5%
25000 - 30000	30	6	20.0%
30000 - 35000	20	8	40.0%
35000 - 40000	7	2	28.6%
40000 - 45000	9	2	22.2%
45000 - 50000	7	3	42.9%
50000 - 55000	4	0	0.0%
55000 - 60000	8	0	0.0%
60000 - 65000	4	0	0.0%
65000 - 70000	6	0	0.0%
70000 - 75000	3	0	0.0%
75000 - 80000	1	0	0.0%
80000 - 85000	1	0	0.0%
85000 - 90000	0	0	0.0%
90000 - 95000	1	0	0.0%
95000 - 100000	0	0	0.0%
Over 100000	2	0	0.0%
Total	127	33	

EXHIBIT V

Plan Name	Participant* Count	Eligibility	Benefit
Atlantic Richfield Retirement Plan	43,000	Employees with Six months Company Service	1.15% of final average salary (3 yrs) up to Social Security Tax Base + 1.5% of the excess
Capital Accumulation Plan (CAP)	25,000	Immediate	1-10% Salary deferral
Savings Plan	23,000	Employees with Six months Company Service and elective deferral of at least 1% to CAP	Company match of $2 for every $1 of employee saving to a maxi-maximum of 4% of salary.
PAYSOP	36,000	Immediate for all full time employees	1/2 percent of payroll
Medical and Dental	36,000**	Immediate for all employees	Medical & Dental Expenses; requires cost sharing by employee.
Life/Survivor Income	36,000	Immediate for All Employees	One times salary
Short Term Disability	36,000	Immediate for All Employees	Depends upon length of employment.
Long Term Disability	28,000	Immediate for All Employees who are full time and under 69½	Represented employees receive 50% of pre disability salary. Others receive 60%, with required contributions for employees earning in excess of $40,000

* Rounded to nearest thousand

** Does not include approximately 40,000 dependents who are also covered

EDINBORO UNIVERSITY of Pennsylvania
EDINBORO, PA. 16444

Department of Economics, Business and Political Science
(814) 732-2409 or 2407

Senator Robert Dole
Chairman of Committee-Finance
Room SD - 219
Senate Office Building
Washington, D.C. 20510

Dear Senator Dole,

Please find attached a copy of the testimony I presented to Secretary Donald Regan and the Treasury Department's Study Committee on tax reform, June 26, 1984 in Washington, D.C.

I possess a comprehensive background in education, public and private accounting, and volunteer tax assistance to low and middle income Americans for many years. Since I do not represent any special interest group or PAC, I feel especially qualified to represent the American public and express what I believe are the realistic problems with the current tax system, and suggest potential solutions.

To summarize my opinions, please refer to Exhibit "A". You will note this graph emphasizes an important fact, which most Americans do not understand, the fact that the graduated income tax portion of our tax law is relatively effective. Consequently, a change in tax computation to the flat tax method will most certainly increase taxes for most American taxpayers. For the same reasons I oppose any type of consumption tax such as national sales tax or the value added tax.

As I have essentially stated in my written testimony, an acceptable solution to the tax reform problem lies in continued refinement and simplification of our current system, or possibly a rather significant change to a modified flat tax system (a graduated flat tax). A modified flat tax system could be easily adapted to a simple tax system ~~such as the~~ method utilized by the state of Pennsylvania. (See Exhibit "B".)

Legislators should be acutely aware of the negative aspects and potential increased tax burden radical tax reform may place on non-business average Americans. As a result, legislators should not allow themselves to be overly influenced by proponents of such tax systems, but represent the best interest of the general public when proposing tax reform.

Thank you for your consideration.

Gerald H Carnes Jr. CPA
Gerald H. Carnes, Jr.
Asst. Prof. - Acctg & Bus.

A member of the State System of Higher Education

EDINBORO UNIVERSITY of Pennsylvania
EDINBORO, PA. 16444

Department of Economics, Business and Political Science
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August 2, 1984

Department of Treasury
Tax Reform Study
P.O. Box 299
Washington, D.C. 20044

As a University Professor, I have instructed basic tax preparation to hundreds of intelligent, but uninformed young citizens, and as a VITA Coordinator and participant I have prepared hundreds of tax returns for low income, unemployed, and retired, etc., taxpayers. Consequently, I believe I possess an understanding of how many low and average income taxpayers view our tax system.

Some of the testimony you have received thus far seems to reflect the opinion that our system is not unduly complicated for most taxpayers and therefore may not require significant change. For example, Mr. D. Berenson testified many taxpayers (40%) are filing short forms and simple returns, which may mean very little except that 60% of the taxpayers are filing longer and more complicated tax returns. Further, it should be noted that extremely complicated questions still often occur even on short filing forms. In reading Mr. Berenson's comments, I wonder how many short forms he prepared last year, or how many problems he discussed with taxpayers in the lower brackets. I do agree with his observation that principally problems are created by the law, but we must not assume that we cannot improve, simplify, and make more understandable a very complicated tax system.

To support my position, I have listed a summary of a mere sampling of actual questions my students and I incurred during the tax season.

Example 1: A divorced wife on little income receives some support from her ex-husband, but she does not know if her ex-husband is claiming exemptions for the two children or if she can claim the exemptions. Since husband and wife do not communicate this is a recurring problem and the wife must maintain and analyze support records each year.

Example 2: A retired, widowed school teacher takes part of her pension as annuity and part in a lump sum so she can take her once-in-a-lifetime trip to Europe. Told by the trustee she can ten-year average, she attempts to complete her own return. In fact, she must understand the qualifications of lump sum distribution, ten-year averaging, and eventually five-year income average distribution.

A member of the State System of Higher Education

Example 3: People receiving unemployment part of the year or one spouse receiving unemployment and the other spouse working. They often are earning less and don't realize they may be liable to pay tax on their unemployment compensation. Also, the computation to complete taxable portion is complicated.

Example 4: Waitress received allocated tips on W-2, not really understanding her obligations/rights concerning her possible disagreement with the allocated amount. Not only her income tax must be paid, but social security tax and Form SE must be filed, plus she has a child in day care and must file Form 2441 and potential Earned Income Credit. She cannot possibly file the return by herself.

Example 5: Mr. & Mrs. Average American Household. He is a teacher who does a little remodeling and lawn care contracting to earn money in the summer. The wife has only a small amount of income as an independent contractor to a local business. They bought a piece of rental property as savings for the children's college education. They must file and understand the following forms:

1040
1040 Sch. A Div.
Sch. B over $400
Sch. C - Husband
Sch. C - Wife
Sch. D - Sold several shares of stock received as gift from parents
Sch. SE - Husband
Sch. SE - Wife
Form 4562 - Depreciation of small business equipment for husband - ACRS
Form 3468 - Purchase of small equipment
Sch. E - Rental Property
4562 - Depreciation for rental property
Form 2441 - Child's day school

Thirteen separate forms must be filed and understood. Again, its impossible for them to accurately complete the tax return themselves.

Example 6: Retired faculty worker invested part of savings into an Oil and Gas Company limited partnership. Now he must compute his windfall profit tax credit.

Example 7: An abandoned working wife has not had any contact with her husband for most of the past year. Having never filed her own tax return, she has questions concerning filing status, exemptions for children, and payment of potential tax liability.

Example 8: An unemployed factory worker performs auto repair work in an old garage building. The wife sells home products as an independent contractor. Both are self-employed and face the problem of computing business income (less than $8000 of earned income), self-employment tax, potential taxability of Unemployment Compensation, potential Earned Income Credit. All of this is completely mind-boggling to such taxpayers, and they cannot afford a $200-300 tax preparation bill. Also, when he finally separated employment he took a small lump sum distribution from his retirement plan and did not elect to rollover. Therefore, he created further tax complications.

Obviously, most of these problems are created by the complicated nature of the tax law. But, we cannot assume the filing forms can no longer be improved or refined. The system, in my opinion, is nearly out of control and needs continual and meaningful improvement.

The Flat Tax concept is not needed to simplify our system. Assuming a person earning $100,000 would pay $20,000 in tax, and a person earning $20,000 would pay $4,000 is unfair and creates greater inequity. Changes could be implemented to eliminate all deductions. But, we must leave intact the graduated income tax rates. Therefore, many improvements to the system may be implemented without applying a Flat Tax.

I could list many more examples of somewhat routine tax situations that create complex difficulties for even the most average taxpayers. I have listed problems faced by predominately low income taxpayers, but as income grows so do the complexities of the tax requirements. I have also explained many complicated portions of the law to what might be termed "middle class" Americans, and their situations also become very confusing and difficult for them to understand.

Consequently, my reason for testifying is to assure that someone counters any general consensus that may occur that the system is functioning in an acceptable fashion.

Finally, I would like to present a few relatively general suggestions I believe may improve the filing system. These suggestions are not intended to be comprehensive at this point, but I would be willing to provide more information if requested. The suggestions merely represent a sampling of the type of changes that could possible improve the system:

1. Continue to simplify forms:

   a. Place simple explanations of the purpose of commonly used forms at the top of the form. This would be similar to the brief description of use at the top of the new 1040 EZ, and Schedule 1- Form 1040A. The explanation tells exactly who may use this form. Uninformed taxpayers are continually puzzled by which form applies to their needs.

   b. Separate Schedule A & B into two different forms, and place as much instruction as possible for these forms on the back. These forms are commonly required by many taxpayers yet, they still often confuse the general public. Because they are listed together, taxpayers believe they are somehow related, when in fact, there is not a relationship at all. Also, taxpayers must seek instructions to complete these forms in their booklet, or elsewhere. I have discovered that any form which contains printed instructions with the form is much easier to understand and complete. (Schedule 1 of Form 1040A has been very helpful and is an example of this suggestion).

   c. Create a new form for computing taxability of Unemployment Compensation. This particular type of income and its potential taxability has been unusually frustrating to unemployed workers. More specific attention should be given to this topic. The form could simply contain information from the worksheet in the tax booklet, but a separate form with instructions would draw stronger attention to the topic and facilitate the computation.

   d. Many retired persons are required to make Estimated Tax Payments. The recent simplification of this form has been very helpful. It continues to be a confusing mystery as to why the dates of payment do not face at regular intervals. The dates should be changed to reflect the regular intervals such as April 15, July 15, October 15, and January 15.

2. Continue to make answers and assistance to taxpayers:

   a. Expand toll free telephone answering service.

2. b. Continue to expand programs such as VITA, possibly to include group tax instruction presented at sites conducive to low income and elderly taxpayers.

   c. Expand local IRS office services to provide assistance in filing returns, answering questions, and providing tax forms.

3. Provide pressure to Congressional bodies to provide changes in the tax law which will create simplification in the filing requirements.

   a. See Copy of PA 40 - Pennsylvania Individual Tax Return. The Pennsylvania return allows for no deductions to individuals. It sometimes draws complaints for that reason, but it is without question very simple. I do not necessarily endorse this system, but it is for your review. This type of form is easily adaptable to a graduated income tax. (Modified Flat Tax)

   b. See Copy of simplified Form 1040 which I created by merely leaving large segments of blank space. Again, I do not necessarily endorse such a form, but it is time responsible bodies became innovative and creative. No viable alternative should be overlooked in your research.

4. Continue to make attempts to create a positive image of the IRS. It will be generally helpful if the general public possesses trust and confidence in this agency. (Please see Editorial from the Meadville Tribune). Most often ignorance of the IRS function and the tax law create distrust when it occurs. Highly publicized taxpayers lecture crosscountry and on the TV shows instructing citizens that they do not have to pay their taxes. Such publicity must be countered in a responsible and professional manner.

5. Increase the number of audits being conducted. I have found the audit procedure to be a tremendously meaningful experience for most individual taxpayers. They gain a greater respect for the responsible IRS representative and a greater understanding of the system. If each taxpayer believed they would be audited once every ten years, they would develop a different perspective of the system.

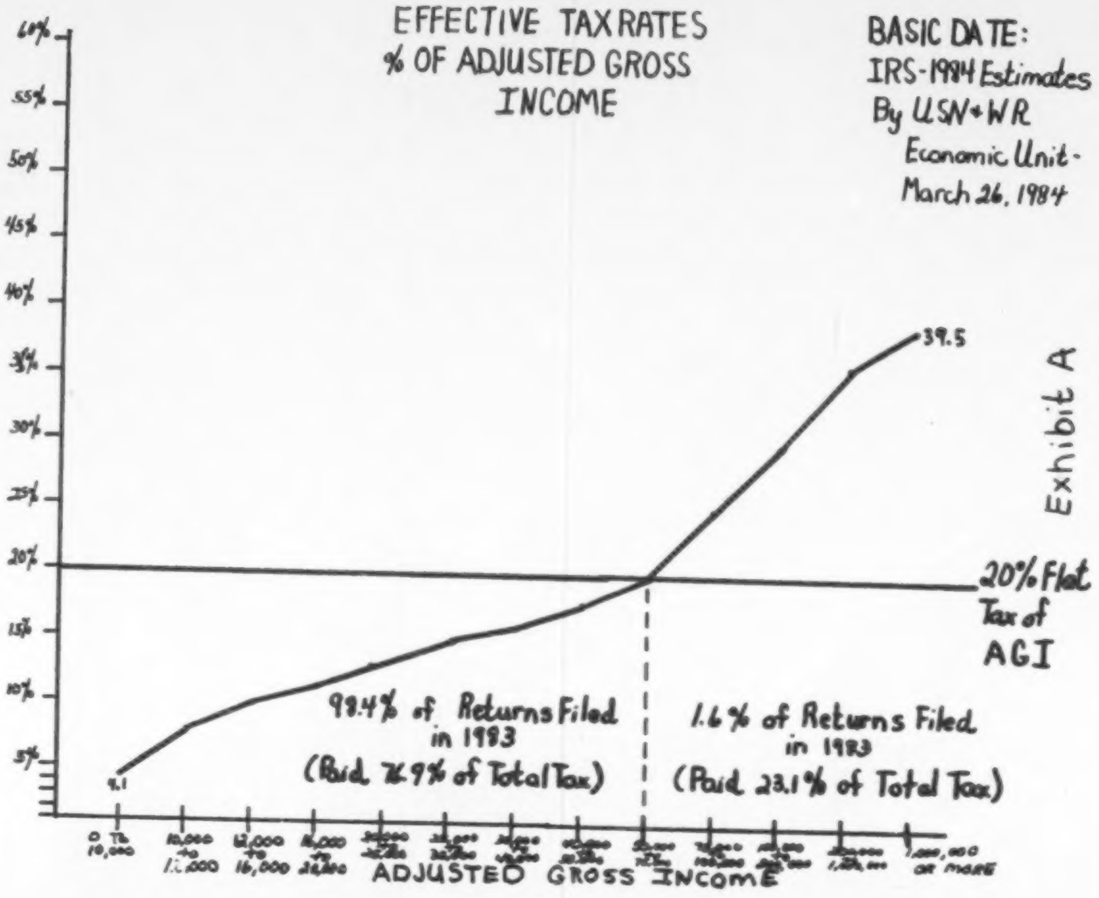
Thank you for the opportunity to submit this testimony. Please feel free to contact me if you require any further information.

Very truly yours,

Gerald H Carnes Jr.

Gerald H. Carnes, Jr.

Exhibit A



EFFECTIVE TAXRATES
% OF ADJUSTED GROSS
INCOME

BASIC DATE:
IRS-1984 Estimates
By USN+WR
Economic Unit-
March 26, 1984

1983
COMMONWEALTH OF PENNSYLVANIA
Individual Income Tax Return

PA 40

For the taxable year January 1 — December 31, 1983

OFFICIAL USE ONLY

Fiscal Year Filer — For other taxable year beginning ________ 1983, ending ________ 198___

PLEASE PRINT OR TYPE

YOUR SOCIAL SECURITY NUMBER

SPOUSE'S SOCIAL SECURITY NUMBER (Even if filing separate return)

Last Name

First name and initial (if joint return, enter both)

Home Address

City or Post Office

State

Zip Code

FILING STATUS (Check One)
S ☐ Single
J ☐ Married, Filing Joint Return
M ☐ Married, Filing Separate Return
Name of Spouse________
F ☐ Deceased, Filing Final Return
Date of Death________

Occupation:
Yours ________
Spouse's ________

RESIDENCY STATUS: (Check One)
R ☐ Resident
P ☐ Part-Year Resident — From ______ To ______
N ☐ Nonresident ________
Name of State

☐ Check here if this is a change of address from last year's return

TELEPHONE NUMBER
(   )

OFFICIAL USE ONLY

School District

CODE (see pages 7 and 8)

ATTACH CHECK OR MONEY ORDER HERE

Income

1a. GROSS COMPENSATION (Wages, salaries, tips, etc.)	1a		
1b. LESS EXPENSES FROM SCHEDULE UE	1b		
1c. TAXABLE COMPENSATION (line 1a less line 1b) ATTACH COPY OF W-2(s) TO BACK OF THIS FORM		1c	
2. NET PROFITS FROM BUSINESS, PROFESSION, OR FARM (Complete Schedule C or F)		2	
3. INTEREST (Complete Schedule A if over $400.00)	3		
4. DIVIDENDS (Complete Schedule B if over $400.00)	4		
5. Add lines 3 and 4 ONLY		5	
6. SALE OR EXCHANGE OF PROPERTY (Complete Schedule D)	6		
7. RENTS, ROYALTIES, PATENTS, AND COPYRIGHTS (Complete Schedule E)	7		
8. ESTATES OR TRUSTS (Complete Schedule J)	8		
9. GAMBLING AND LOTTERY WINNINGS	9		
10. Add lines 6, 7, 8 and 9 ONLY		10	
11. PENNSYLVANIA TAXABLE INCOME (Add lines 1c, 2, 5 and 10)		11	

THIS RETURN MUST BE FILED ON OR BEFORE APRIL 16, 1984

ALLOW AT LEAST SIX WEEKS FOR REFUND CHECKS

BE SURE TO COMPLETE SCHOOL DISTRICT DATA

Tax

12. TAX LIABILITY—2.45% OF LINE 11 (Multiply line 11 by .0245)		12	

Tax Credits

13. TOTAL PA. INCOME TAXES WITHHELD (From Attached W-2's)	13		
14. PA. ESTIMATED TAX PAYMENTS (Include extension payments and allowed credit from 1982 return)	14		
15a. TAXES PAID BY PA. RESIDENTS TO OTHER STATES (Complete Schedule G)	15a		
15b. TAX FORGIVENESS CLAIMED ON SCHEDULE SP (Complete Schedule SP)	15b		
15c. EMPLOYMENT INCENTIVE PAYMENT CREDIT (Complete PA Schedule W)	15c		
16. TOTAL CREDITS (Add lines 13, 14, 15a, 15b and 15c)		16	

OFFICIAL USE ONLY

Tax Due or Overpayment

17. If line 12 is greater than line 16 enter the difference. This is the TAX DUE Make checks payable to Pennsylvania Department of Revenue		17	
18. If line 16 is greater than line 12 enter the difference. This is the OVERPAYMENT		18	
19. Amount of Line 18 to be: (a) REFUNDED	19a		
(b) CREDITED ON 1984 ESTIMATED TAX	19b		
(c) DONATED TO WILD RESOURCE CONSERVATION FUND	19c		

Write Social Security Number on check or money order.

The total of lines 19a, 19b, and 19c cannot exceed line 18.

Sch. SP

YOU MUST COMPLETE 20a AND 20b IF SCHEDULE SP IS USED

20a. NUMBER OF DEPENDENTS CLAIMED ON SCHEDULE SP	20a	
20b. TOTAL INCOME AS REPORTED ON SCHEDULE SP line 8	20b	

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

Sign here

________ Your signature ________ Date

________ Spouse's signature (if filing jointly, BOTH must sign even if only one had income)

________ Signature of preparer, other than taxpayer, based on all information of which he has any knowledge ________ Date

(   ) (Telephone No.)

EXHIBIT "B"

PA-40SP (9-83)
SCHEDULE SP
DEPARTMENT OF REVENUE

COMMONWEALTH OF PENNSYLVANIA
Special Tax Provisions Schedule
(DO NOT FILE IF A DEPENDENT)

FOR THE TAX YEAR
1983

Name as shown on form PA-40	SOCIAL SECURITY NUMBER	SPOUSE'S SOCIAL SECURITY NUMBER

A
1. Are you a dependent spouse or child? ☐ Yes ☐ No
2. Are you claimed as a dependent on your spouse's Schedule SP? ☐ Yes ☐ No
3. Are you being claimed as a dependent child for Federal tax purposes? ☐ Yes ☐ No
If you answered "Yes" to questions 1, 2 or 3, DO NOT FILE A SCHEDULE SP.
4. Are you a student? ☐ Yes ☐ No
5. If married, is your spouse filing a Schedule SP? ☐ Yes ☐ No
6. Are you a widow/widower? ☐ Yes ☐ No

B 1. Total number of dependent children in family__________

List below all dependents you are entitled to claim—DO NOT INCLUDE YOURSELF. (Additional information may be attached on a separate sheet)

DEPENDENTS

DEPENDENT'S NAME	AGE	RELATIONSHIP (Spouse or Child)	SOCIAL SECURITY NUMBER

Enter here and on line 20a of PA-40 total number of dependents __________
Note: See Page 26 For SP Worksheet.
2. Total Other Income from line C-6 of SP Worksheet:
Claimant $__________ Spouse $__________

C If married, complete Columns A & B. When claiming tax forgiveness, both spouses must file separate PA-40's if each has taxable income.

ELIGIBILITY INCOME DETERMINATION

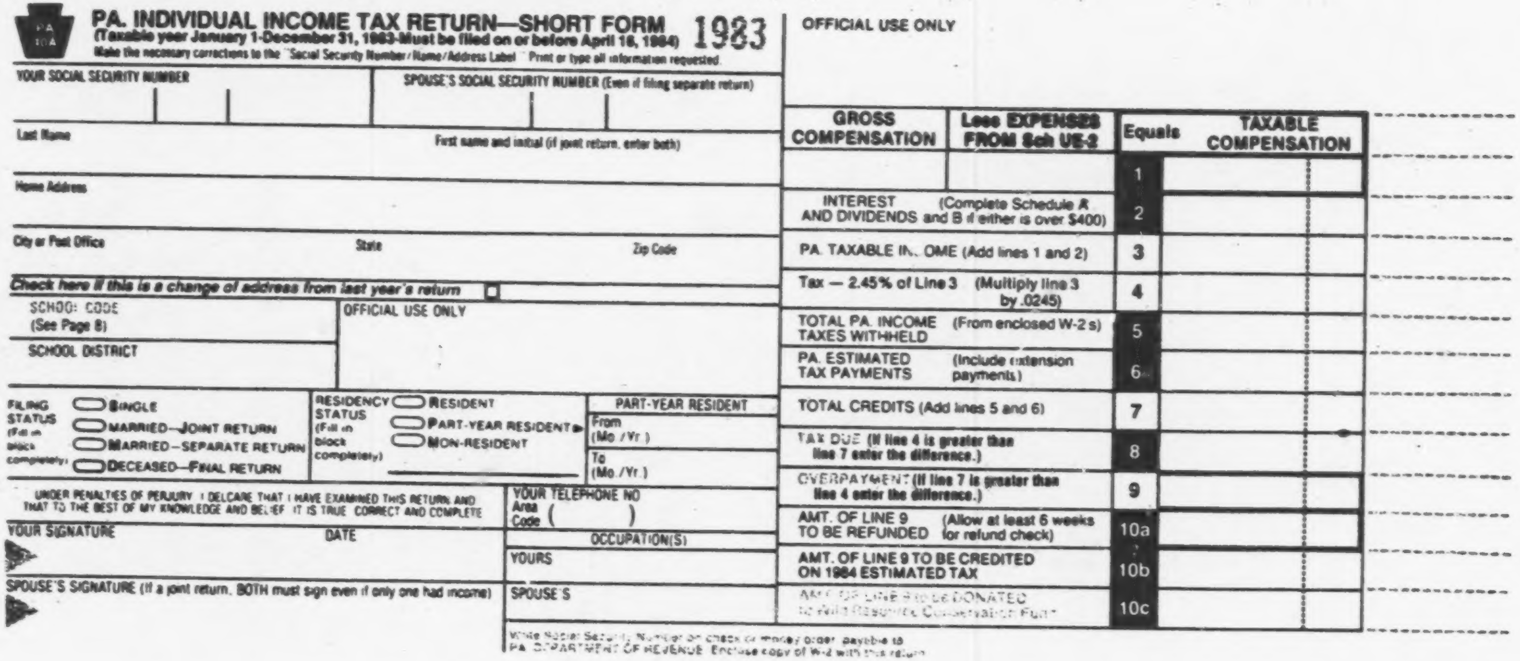
		COLUMN A CLAIMANT'S INCOME	COLUMN B SPOUSE'S INCOME
1. TOTAL TAXABLE INCOME FROM LINE 11 OF FORM PA-40	1		
2. NON-TAXABLE INTEREST, DIVIDENDS, AND GAINS (Worksheet line B1)	2		
3. ALIMONY/CHILD SUPPORT (Worksheet line B2)	3		
4. LIFE INSURANCE AND INHERITANCE PROCEEDS (Worksheet line B3)	4		
5. GIFTS, AWARDS, AND PRIZES (Worksheet line B4)	5		
6. NONRESIDENT INCOME (Worksheet line B5)	6		
7. ALL OTHER INCLUDABLE INCOME (Worksheet lines B6 through B9)	7		

D

FORGIVENESS COMPUTATION

8. TOTAL INCOME—LINES 1 THROUGH 7 ABOVE (Enter Claimant's Total Income in Column A and on line 20b of PA-40)	8		
9. PENNSYLVANIA PERSONAL INCOME TAX (From line 12 of form PA-40)	9		
10. LESS TAXES PAID TO OTHER STATES (Line 15a, form PA-40)	10		
11. SUBTRACT LINE 10 FROM LINE 9 AND ENTER DIFFERENCE	11		
12. PERCENTAGE OF FORGIVENESS (See Income Table for decimal equivalent)	12		
13. AMOUNT OF SPECIAL TAX FORGIVENESS (Multiply line 11 by line 12) Enter here and on line 15b of PA-40	13		

ATTACH ALL COPIES OF W-2's HERE



PA. INDIVIDUAL INCOME TAX RETURN—SHORT FORM 1983
(Taxable year January 1-December 31, 1983-Must be filed on or before April 16, 1984)
Make the necessary corrections to the "Social Security Number/Name/Address Label." Print or type all information requested.

PA 10A

OFFICIAL USE ONLY

YOUR SOCIAL SECURITY NUMBER
SPOUSE'S SOCIAL SECURITY NUMBER (Even if filing separate return)
Last Name
First name and initial (if joint return, enter both)
Home Address
City or Post Office
State
Zip Code
Check here if this is a change of address from last year's return ☐
SCHOOL CODE (See Page 8)
OFFICIAL USE ONLY
SCHOOL DISTRICT

FILING STATUS (Fill in block completely)
○ SINGLE
○ MARRIED—JOINT RETURN
○ MARRIED—SEPARATE RETURN
○ DECEASED—FINAL RETURN

RESIDENCY STATUS (Fill in block completely)
○ RESIDENT
○ PART-YEAR RESIDENT ▶
○ NON-RESIDENT

PART-YEAR RESIDENT
From (Mo./Yr.)
To (Mo./Yr.)

UNDER PENALTIES OF PERJURY I DELCARE THAT I HAVE EXAMINED THIS RETURN AND THAT TO THE BEST OF MY KNOWLEDGE AND BELIEF IT IS TRUE CORRECT AND COMPLETE

YOUR TELEPHONE NO Area Code (   )
YOUR SIGNATURE
DATE
OCCUPATION(S)
YOURS
SPOUSE'S SIGNATURE (If a joint return, BOTH must sign even if only one had income)
SPOUSE'S

GROSS COMPENSATION	Less EXPENSES FROM Sch UE-2	Equals	TAXABLE COMPENSATION
		1	
INTEREST AND DIVIDENDS (Complete Schedule A and B if either is over $400)		2	
PA. TAXABLE INCOME (Add lines 1 and 2)		3	
Tax — 2.45% of Line 3 (Multiply line 3 by .0245)		4	
TOTAL PA. INCOME TAXES WITHHELD (From enclosed W-2's)		5	
PA. ESTIMATED TAX PAYMENTS (Include extension payments.)		6	
TOTAL CREDITS (Add lines 5 and 6)		7	
TAX DUE (If line 4 is greater than line 7 enter the difference.)		8	
OVERPAYMENT (If line 7 is greater than line 4 enter the difference.)		9	
AMT. OF LINE 9 TO BE REFUNDED (Allow at least 6 weeks for refund check)		10a	
AMT. OF LINE 9 TO BE CREDITED ON 1984 ESTIMATED TAX		10b	
AMT. OF LINE 9 to be DONATED to Wild Resource Conservation Fund		10c	

Write Social Security Number on check or money order payable to PA DEPARTMENT OF REVENUE. Enclose copy of W-2 with this return.

Form **1040** **U.S. Individual Income Tax Return** **1983** (L)

For the year January 1–December 31, 1983, or other tax year beginning 1983 ending 19 | OMB No. 1545-0074

Use IRS label. Otherwise, please print or type.

Your first name and initial (if joint return, also give spouse's name and initial) Last name | Your social security number

Present home address (Number and street, including apartment number, or rural route) | Spouse's social security number

City, town or post office, State, and ZIP code | Your occupation | Spouse's occupation

Presidential Election Campaign ▶ Do you want $1 to go to this fund? ☐ Yes ☐ No
If joint return, does your spouse want $1 to go to this fund? ☐ Yes ☐ No
Note: *Checking "Yes" will not increase your tax or reduce your refund.*

For Privacy Act and Paperwork Reduction Act Notice, see Instructions.

Filing Status

Check only one box.

1 ☐ Single
2 ☐ Married filing joint return (even if only one had income)
3 ☐ Married filing separate return. Enter spouse's social security no. above and full name here ____
4 ☐ Head of household (with qualifying person). (See page 6 of Instructions.) If the qualifying person is your unmarried child but not your dependent, write child's name here ____
5 ☐ Qualifying widow(er) with dependent child (Year spouse died ▶ 19). (See page 6 of Instructions.)

Exemptions

Always check the box labeled Yourself. Check other boxes if they apply.

6a ☐ Yourself ☐ 65 or over ☐ Blind
b ☐ Spouse ☐ 65 or over ☐ Blind
Enter number of boxes checked on 6a and b ▶ ☐

c First names of your dependent children who lived with you ____
Enter number of children listed on 6c ▶ ☐

d Other dependents (1) Name	(2) Relationship	(3) Number of months lived in your home	(4) Did dependent have income of $1,000 or more?	(5) Did you provide more than one-half of dependent's support?

Enter number of other dependents ▶ ☐

e Total number of exemptions claimed
Add numbers entered in boxes above ▶ ☐

List and Describe Taxable Income:

Total Income ____

Less: Exemption Allowance ($1000 X Line 6e) ____
Taxable Income ____

Tax (Tax Tables) ____

Taxes Paid:
Withheld From Pay W-2 ____
Estimated Tax Payments ____
Earned Income Credit ____

Refund ____
Tax Due ____

Signature____________________
Date ____________________

The Meadville Tribune

Tuesday, June 12, 1984

'Overzealous' Indeed!

Nearly everyone gripes about paying taxes. Some are more vocal about it than others, especially if they believe their hard-earned tax dollars are being wasted in government spending sprees.

Unlike citizens of many other countries, Americans, fortunately, enjoy the freedom to express how they feel. And the subject of taxes generates an entire spectrum of emotions from purple rage to tongue-in-cheek barbs.

Unfortunately, some of those at the Internal Revenue Service apparently are not amused and have been responding to those who dare speak out by slapping them with hefty fines.

Incidents which have been cited in recent national wire service reports are frightening, to say the least, and they make one wonder if those in power in Washington, D.C., have forgotten that Americans still have the right to express their views.

An Ohio woman, for example, paid her taxes in full, but was fined $500 for writing a protest of military spending on her return.

A woman from the southeastern U.S., who had earned less than $3,000 for the entire year, dutifully paid her $35 tax debt to the IRS. Beneath the signature on her check, however, she reportedly typed: "Signed involuntarily under penalty of statutory punishment." For that, she, too, was fined $500. But IRS agents didn't stop there. They also seized her meager bank account of $140 and filed a lien against her home.

These two United States citizens are among more than 5,000 taxpayers who currently face fines for using their tax returns to exercise their constitutional right of free speech.

It now appears that taxpayers fined for writing insults or protests on their returns may be the victims of "overzealous interpretations" (by IRS field offices) of a new law.

The law in question allows the IRS to prosecute people who file "frivolous" returns — such as claiming hundreds of dependents or claiming clearly unallowable deductions.

But the wire service report quotes an IRS official as saying there are no guidelines calling for prosecution when a taxpayer writes something extra on a return.

If there's no such law, all legal proceedings of this type should be halted at once.

Any fines paid should be refunded — with interest — immediately. Citizens subjected to such harassment should expect a full apology from someone at the top of the Reagan administration. Any and all legal records naming these taxpayers must be destroyed.

What's more, all IRS employees responsible for this intrusion on American rights of free speech should find themselves on the outside of the agency looking in.

On the other hand, if such an outrageous and repressive regulation is, somehow, legally in effect, it should be abolished at once.

STATEMENT OF

GEORGE A. STRICHMAN
CHAIRMAN OF THE BOARD
COLT INDUSTRIES INC

ON BEHALF OF THE

COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

SUBMITTED TO THE

SENATE FINANCE COMMITTEE

UNITED STATES SENATE

HEARING ON MAJOR TAX REFORM

September 20, 1984

INTRODUCTION

The Committee for Effective Capital Recovery is a volunteer coalition of over 600 business firms and more than 50 business associations. It is representative of virtually all segments of industry including manufacturing, retail, minerals, transportation and utilities. A list of the member companies and supporting associations is attached (see Appendix A).

The Committee has long been active in efforts to improve, strengthen and make permanent, capital cost recovery measures, specifically the investment tax credit and depreciation allowances.

The purpose of this hearing is to consider the impact of various proposals to fundamentally reform our tax system. Numerous legislative proposals for major tax reform have already been put forth and new ones are appearing on what seems to be almost a daily basis. Because the repercussions of such fundamental structural changes could be enormous, far-reaching and costly, these proposals should be carefully studied prior to any Congressional action. The Finance Committee is to be commended for the in-depth consideration being undertaken with this series of hearings.

At the outset, I would like to point out that the nation is still reeling from the effect of seven major tax measures enacted in just the last decade, the full impact of which is probably yet to be determined. Stability and certainty are more important to the nation's economic health at this stage than any fundamental change or reform.

The Committee for Effective Capital Recovery stands firmly behind the Accelerated Cost Recovery System and the improvements in the investment tax credit adopted by Congress in 1981. Recent findings indicate that the capital recovery tax provisions are among the most significant factors that have lead to the current economic recovery; therefore, the Committee believes that their maintenance and improvement should be a priority in devising any new or alternative tax scheme. To the extent that any of the reform proposals would eliminate or weaken these vital incentives to capital investment, we believe they are misguided and potentially damaging to the economy.

We also believe that the curtailments made to the 1981 capital formation provisions by the Tax Equity and Fiscal Responsibility Act of 1982 should be reversed, specifically to restore the full benefit of the investment tax credit and the scheduled increases in the rate of recovery.

While the Committee's priority goal is to maintain continuity in the current capital recovery provisions of the tax code and while we do not advocate any increase in taxes at this time, the Committee does also wish to respond to the Finance Committee's request for our views on alternative forms of taxation such as transaction or consumption type taxes. The principle underlying consumption taxes is consistent with the goal of our organization -- to encourage capital formation through incentives for savings and investment. Because, as yet, no specific legislative proposals for a VAT, a national sales tax, or other consumption-type taxes have been introduced in the Senate, it seems premature to comment here on particulars of such a proposal. It is possible to note, however, that the theoretical models for consumption-based taxes are economically efficient and appear to have a favorable impact on capital formation.

Overall, the most important principle to guide consideration of tax reform proposals should be that nothing is done to endanger the strong economic recovery now underway. In recent months, there has been a dramatic turnaround in the factors affecting the economic health of this country. Treasury Department findings indicate that investment is leading the recovery, growing at three times the rate of consumer spending. And the disastrous decline in U.S. productivity has finally been halted, largely as a result of new capital investment. Therefore, despite occasional comments to the contrary by skeptics, Congress has reason to be satisfied that its tax incentives are performing as favorably as predicted.

Any adverse change in our tax policy pertaining to capital recovery at this time could throw business planning into disarray and frustrate the national goal of stimulating savings and investment, thereby seriously threatening the economic recovery.

I. THE PROBLEMS IN U.S. ECONOMY LEADING TO THE 1981 TAX PROVISIONS

Prior to the passage of the Economic Recovery Tax Act of 1981 (ERTA), the United States was facing severe economic problems. Among other factors, the country was experiencing a serious decline in productivity with a concurrent loss of competitiveness with other nations. By 1979-1980, the rate of productivity growth had actually decreased as a percentage change and the United States had fallen dangerously behind its trading partners in that economic measure, ranking last when compared with Japan, France, Germany, Canada, and the United Kingdom. At the same time, the United States also ranked last when comparing United States investment as a percentage of gross domestic product with that of these same five industrialized nations.

In conjunction with this drop in the rate of productivity growth came high inflation and disappointingly small gains in real income.

A number of studies conducted to determine the cause of this downward trend in the economy reached the same conclusion: underinvestment in plant and equipment was a major source of the problem.1/

By 1981, Congress recognized the urgent need for improved capital recovery measures. Too many corporations were

---

1/ See e.g., Productivity Policy: Key to the Nation's Economic Future, Committee for Economic Development (1983).

paying large federal taxes on illusory profits -- profits that resulted solely from the impact of inflation. Such taxes led to reduced corporate cash flows and inadequate capital investments. This had a seriously deleterious impact on the economic health of the country and its ability to compete with other nations.

Recognizing that a key to economic recovery was increased savings and investment in plant and equipment, Congress adopted the Accelerated Cost Recovery System (ACRS), i.e., the 10-5-3 year period allowances, as a part of ERTA.

These changes in depreciation allowances provided that the cost of most eligible property could be recovered in three, five, or ten years, depending upon the classification of property. Plant and equipment investments by utilities were provided a separate 15 year classification, as was real estate. The 1981 tax law also made beneficial changes in the recovery methods by increasing the rate of recovery. Further increases were scheduled to be phased-in in 1985 and 1986.

Finally, under ERTA, three-year recovery property was eligible for a six percent investment tax credit and five- and ten-year recovery property was eligible for a full ten percent investment tax credit.

Had these provisions been left intact, we might well be further along the road to recovery than we are now. Unfortunately, in 1982 -- barely one year after ERTA was enacted -- the benefits provided by the ACRS provisions were curtailed.

In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress amended the capital recovery provisions by requiring taxpayers to reduce the basis of their assets by 50 percent of the amount of investment tax credits (and other credits related to the property) or, alternatively, reduce the investment tax credit directly by two percentage points. Additionally, TEFRA limited the use of the investment tax credit to only 85 percent of the regular tax liability, rather than 90 percent; it also repealed the increased rates of recovery scheduled to go into effect in 1985 and 1986. Under ERTA, cost recovery had been scheduled to accelerate to the 175 percent declining balance method in 1985 and the 200 percent declining balance method in 1986.

The fact that Congress initiated consideration of another major tax bill almost immediately after passage of the substantial and long-overdue changes in ERTA left business managers in understandable uncertainty vis-a-vis the implications of changing legislation. Some business investment plans were adversely affected because the modifications in TEFRA negatively altered the projected rate of return available from such investment.

However, despite the fact that the 1982 tax changes may well have delayed the arrival of the recovery, the basic changes enacted in ERTA were of sufficient positive impact that the economic recovery is now well underway.

II. THE 1981 TAX PROVISIONS ARE LARGELY RESPONSIBLE FOR ECONOMIC RECOVERY

The tax changes in the capital recovery allowances have had a large and favorable impact on the level of investment. According to the latest quarterly survey of capital expenditure plans by the Department of Commerce, real capital expenditures are expected to increase 14.8 percent this year, a major improvement over the recessionary period and a very high rate by all historical standards.

Earlier this year, Charles McLure, Deputy Assistant Secretary for Tax Analysis at Treasury, testified before the Senate Finance Committee's Subcommittee on Oversight of the IRS as to the beneficial impact of these tax provisions:

> The changes in taxation of business capital have lowered costs of capital to capital-intensive industries, reduced the tax bias favoring capital in the household sector over capital used by business, and increased incentives to invest in more durable capital. All of these changes should have beneficial effects on the growth of productivity in future years. In fact, real business fixed investment has grown 12.6 percent in the first four quarters of the current recovery, compared to an average of 5.7 percent in the first year of the five previous recoveries between 1954 and 1975. 2/

The fact is that, since the depth of the recession, the rate of growth in fixed business investment has been the highest rate of growth of any postwar recovery period.

2/ Statement of Charles E. McLure, Jr., Deputy Assistant Secretary for Tax Analysis, Department of Treasury, before the Oversight Subcommittee of Senate Finance Committee, April 13, 1984.

Recent surveys confirm that these improvements in business investment are a direct result of the tax changes. Allen Sinai, Andrew Lin, and Russell Robbins of Data Resources, Inc., analyzed the combined impact of the 1981 and 1982 tax changes, and compared it to what would have occurred in our economy had pre-ERTA legislation remained in effect. It was their conclusion that ACRS and the equipment investment tax credit avoided a more serious decline in business capital outlays than might have been expected during the long and severe economic downturn of 1981-82. And they estimated that additional investments in plant and equipment would increase by a range of $9 billion to $17 billion a year from 1983 to 1985.

Also, according to this study, ERTA has had a major beneficial impact on savings. In 1981 and 1982, the estimates of additional savings are $12.7 billion and $31.1 billion. And for 1983-85, the net effect of the tax law changes is estimated to be $58.3, $72.3, and $80 billion respectively.

Thus, Sinai, Lin, and Robbins concluded that the overall impact of the tax changes was very positive:

> [I]f there had been no [tax changes], the U.S. economy would have performed considerably worse in 1981 and 1982 than actually was the case. Simulation of a no [tax change] case . . . lowered growth in real GNP 0.3 and 1.3 percentage points in 1981 and 1982. For 1982, the resulting decline of real GNP was 3 percent, by far the deepest downturn since the early 1930's. Both personal and business saving also were down sharply. On balance, it would appear that the tax changes . . .

> have been and will be positive for the U.S. economy . . . 3/

The statistics on productivity have also shown a remarkable improvement since mid-1982. In fact, the Department of Labor recently reported an increase in productivity for the eighth consecutive quarter, the longest period of productivity growth since 1966-68.

When compared with the productivity levels of other industrialized nations this same improvement trend can be noted. The chart below shows the average annual percentage change in productivity for the U.S. compared with five of its major trading partners. While the United States ranked a dismal last in 1979, it is now second. Improvement has been steady from the time the ERTA tax changes were proposed, except for the year TEFRA was enacted.

Average Annual Increases of Output Per Hour in Manufacturing*

	1960-78	79	80	81	82	83
Japan	9.2	8.9	9.5	5.5	8.1	5.7
France	6.1	4.5	1.5	2.7	5.6	6.1
Germany	5.4	4.7	1.4	2.3	1.7	4.6
Canada	4.0	2.8	-2.2	2.6	-2.5	6.8
United Kingdom	3.6	1.1	-1.1	6.6	3.0	6.1
United States	2.9	.7	.2	3.5	1.2	6.2
U.S. Rank	6	6	4	3	5	2

*Source: U.S. Department of Labor, Office of Productivity and Technology, Division of Foreign Labor Statistics and Trade, June 1984.

3/ Sinai, Lin, & Robbins, Taxes, Savings, and Investment: Some Empirical Evidence, 36 Nat'l Tax J. 321, 344 (1983).

One of the primary factors in improved productivity is the modernization of plants and equipment. Last year, for the first time in a decade, the United States edged out Japan in the race for the world's newest, most modern factories.[4/] In 1983, United States plants and equipment averaged 5.42 years old, compared with Japan's 5.67 years. This is remarkable in light of the picture just a decade ago when, in 1974, the United States factories averaged 7.26 years old, compared with Japan's 5.01 years.

Finally, these tax provisions have assisted the United States in developing and maintaining an increasingly variegated industrial economy. While basic or more traditional industries have directly benefited from the investment tax credit and accelerated depreciation through the ability to vastly increase investment in new and improved plant and equipment, there has been a concurrent benefit to the research intensive industries because so much of the capital investment being made by industry is in computers and other "high tech" equipment. Thus, the research and development oriented industries are greatly benefiting from these tax provisions as well, albeit in the form of direct profits.

It appears, therefore, that the enactment of ERTA in 1981 has been one of the leading causes of the current economic recovery.

4/ USA Today, September 20, 1984, at 1, Section B (based on data from Japan Economic Institute and Nikkei Economic Electronic Databank System for Japan).

III. ADVERSE CHANGES MADE BY TEFRA SHOULD BE REVERSED

As previously noted, the investment tax credit and accelerated depreciation provisions of ERTA have formed the basis of renewed economic growth following the recession by encouraging capital investment and by restoring business confidence. The most beneficial action that Congress could take at this time to maintain the momentum of this economic recovery would be to reverse the changes made by TEFRA.

Cost recovery deductions should be allowed for 100 percent of the cost of a depreciable asset for which the investment tax credit is allowed. Also, the limitation on the amount of income tax liability that may be offset by the investment tax credit should be restored to the level prior to TEFRA, i.e., to 90 percent.

Finally, the further accelerations in depreciation scheduled for 1985 and 1986 should be put back into effect. Under ERTA, cost recovery was scheduled to accelerate in 1985 to reflect the 175 percent declining balance method with a switch to the sum-of-the-years-digits while, in 1986, it was scheduled to further accelerate to reflect the 200 percent declining balance method with a switch to the sum-of-the-years-digits.

Unfortunately, our economy was not given ample opportunity to experience the full benefits of ERTA. Business investments require a long planning period prior to implementation, and, thus, some investment plans, initiated in reliance on ERTA, were never implemented because of the enactment of

TEFRA. If the capital recovery provisions of ERTA had remained in place, this country would have been much further along in redressing the inherent and long-standing bias in our federal tax laws that reward consumption at the expense of savings and investment. However, despite TEFRA's substantial dilution of these necessary incentives to investment, there are those who would actually propose the elimination of the investment tax credit and accelerated depreciation.

IV. ADVERSE CHANGES IN THE INVESTMENT TAX CREDIT AND DEPRECIATION MAY JEOPARDIZE THE ECONOMIC RECOVERY

Among some economists and Members of Congress, there appears to be growing interest in the concept of a "flat" tax. While the idea of a simple, flat rate which either reduces or eliminates deductions, exemptions, credits, etc. has a certain appeal, this approach would pose serious problems for the economy to the extent that it would reduce or eliminate incentives for savings and investment.

The capital and investment needs of industry and their impact on the U.S. economy have been closely studied over many years by both private and government economists. In light of the information gathered, Congress carefully crafted a response to those needs in the form of capital investment incentives in the tax code. The investment tax credit has been in effect, except for two short periods, since 1962, and accelerated depreciation allowances have been in effect in some form since

1954. Both incentives have been fine-tuned over the years to meet this country's changing economic needs and they are successfully accomplishing their goals.

It is true that a flat tax approach at a reduced rate would allow the accumulation of additional cash that could theoretically be used for investment. However, absent the investment tax credit and capital recovery provisions, business would have little tax incentive to invest. On the other hand, the credit and depreciation provisions directly encourage the use of accumulated cash for productive purposes. This is because the only way that businesses can take advantage of the tax benefits provided by these incentives is to actually make the required investments in plant and equipment.

There exists a number of economic factors which indicate that the current levels of capital expenditures, while relatively high at this time, will not be adequate for the future. One factor that will determine future productivity growth is the amount of investment per worker. The capital that is required to maintain the same rate of increase in investment per worker is, of course, dependent upon the size of the labor force. Largely due to the expected higher participation rate of women in the labor force, the projected growth rate for the period from 1977 to 1985 is about two percent, while the pre-1970's figure is closer to one percent.5/ If capital

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5/ 121 Capital Goods Review, Machinery and Allied Products Institute, (August 1984).

expenditures do not increase over current levels, the result will be fewer jobs available.

Secondly, high interest rates have a negative impact on capital investment, causing businesses to cancel or delay planned investments in plant and equipment. At this time, the impact of high rates has been offset by a fall in the equity costs of capital, lower inflation rates, and accelerated depreciation. The existing capital recovery tax incentives actually provide an internal source of funds from which such investments can be made without borrowing. Any adverse change in these incentives, however, could have a disastrous effect on business investment.

Finally, the United States balance of trade is now in serious deficit, over $50 billion in the first half of 1984. While there are numerous reasons for this reversal, one fundamental reason is the high capital costs in the United States. In 1983, a study sponsored by the American Business Conference found that the real cost of capital in the United States is three times the level of Japan and is a primary factor in the growing import penetration by that country.6/ Without maintaining and improving the current investment incentives in our tax code, it could become impossible to turn this trade deficit around.

6/ G. Hatsopoulos, High Cost of Capital: Handicap of American Industry (1983) (study sponsored by the American Business Conference and Thermo Electron Corporation).

Thus, for all of the reasons cited above, the retention of capital cost recovery provisions currently in the tax code is essential to the country's economic health. In fact, improvements are desirable to maintain productivity growth and competitiveness overseas. Any tax reform proposal which recommends the elimination or dilution of such incentives will seriously jeopardize the nation's economic future.

V. TRANSACTION TAXES AS AN ALTERNATIVE TO AN INCOME-BASED TAX SYSTEM

While our comments to this point have been directed to the needs of the economy under an income-based tax system, and have been limited to responding to proposed changes in that system such as the modified flat tax proposals, our testimony would be incomplete if it did not also address those proposals which suggest that the current income-based tax system should be replaced with a system that taxes transactions or consumption rather than income.

It is fairly well understood that the traditional income tax system has at least one serious flaw -- it is inherently biased against savings. In considering the influences on capital investment, one finds that few factors are more important than the nation's rate of savings -- thus, this flaw has far-reaching ramifications for the economy.

To compensate for this bias, the income tax system has been infused with a number of incentives to encourage business investment and savings and these provisions have been modified over time to increase their effectiveness and responsiveness to the changing economic picture. Thus, in 1954, the concept of accelerated depreciation was first introduced; the investment tax credit was created in 1962; by 1971 the Asset Depreciation Range (ADR) system was in place; and, in 1981, the Accelerated Cost Recovery System (ACRS) was adopted. As refined over the years, these cost recovery provisions have proven to be very effective in encouraging capital formation.

Another way of encouraging savings and, thus, capital investment, however, is to levy a tax on expenditures rather than income. By exempting savings and investment from taxation, this type of tax creates a favorable climate for capital formation and is thus consistent with the goals of the Committee for Effective Capital Recovery.

The concept of a consumption tax in the long run merits the continuing interest of the Congress in the upcoming years. In the event that an irresistible push for tax reform and tax simplification develops at some point in the future, consumption taxes should receive full consideration as a replacement, not an add-on for current taxes. In the present climate of economic recovery, tax revision should be revenue neutral.

SUMMARY

Congress is faced with the rather overwhelming task of considering a fundamental restructuring of the tax system. The Committee for Effective Capital Recovery urges careful consideration of the impact of these so-called reform proposals on the productivity and economic growth of the nation.

The Committee favors stability and continuity in the tax system. The crucial capital recovery provisions of the 1981 tax bill were barely in place when their effectiveness was diminished by the negative changes in the 1982 bill. Ideally, the curtailments enacted in 1982 should be reversed. At a minimum, the current accelerated depreciation and investment tax credit system should be maintained.

As predicted, these capital recovery provisions have proven extremely effective in the short period of time that they have been in place. The elimination or dilution of these incentives, as proposed in a number of the tax reform bills being considered, could seriously jeopardize the current economic recovery. That well-worn adage about not tinkering with something that is working is an appropriate caution in this situation.

On alternatives to the income tax system, we simply note that consumption taxation favors savings and investment and thus promotes the goal of capital formation. As such, the concept of a consumption tax in the long run merits the continuing interest and consideration of Congress.

Appendix A

COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

MEMBER COMPANIES

ACF Industries Incorporated
ALUMAX, Inc.
AMAX, Inc.
AMCA International Corporation
AMP Incorporated
ASARCO, Incorporated
AXIA Incorporated
Abex Corporation
Acme-Cleveland Corporation
Aileen, Inc.
Air Products and Chemicals Inc.
Airco, Inc.
Akzona Incorporated
Albany International Corp.
Allegheny International, Inc.
Allegretti & Company
Allen-Bradley Co.
Allied Products Corporation
Allis-Chalmers Corporation
Aluminum Casting & Engineering Co.
Aluminum Smelting & Refining Co.
Amerace Corporation
American Brands, Inc.
American Can Co.
American Financial Corporation
American Greetings Corporation
American Hoechst Corporation
American Hoist & Derrick Co.
American International Group, Inc.
American Maize Products Company
American Motor Inns Inc.
American Natural Resources System
American Petrofina, Inc.
American Thread Company
Ampex Corporation
Amphenon Products
Amtel, Inc.
Anchor Hocking Corporation
Apache Corporation
Arcata National Corporation
Arkansas Best Corporation
Arrow Gear Co.
Arvin Industries, Inc.
Ashland Oil, Inc.
Atlantic Metals Corporation
Atlantic Richfield Company
Automatic Catering, Inc.
Avnet, Inc.
Avon Products, Inc.

Bache Group Inc.
Ball Corporation
Baltimore Gas and Electric Co.
Bandag, Inc.
Bank of Virginia
BankAmerica Corporation
Barry Wright Corp.
Bartlett and Company, Grain
Bartlett-Brainard & Eacott, Inc.
Baxter Travenol Laboratories Inc.
Bayliner Marine Corporation
Beard Oil Company
Beatrice Foods Co.
Beech Aircraft Corporation
Belden Corp.
Bell & Howell Co.
Bemis Company, Inc.
Beneficial Corporation
The Berkline Corporation
Betz Laboratories, Inc.
Big V Supermarkets, Inc.
Binney & Smith, Inc.
Black & Decker Mfg. Co.
Blandin Paper Co.
Bloom Engineering Company, Inc.
Blount, Inc.
Blue Bell, Inc.
Blue Bird Body Company
Blue Ridge Stone Corp.
The Boeing Company
Bowater North America Corporation
Brown Transport Corporation
Brunswick Corporation
Brush Wellman Inc.
Bucyrus-Erie Company
The Budd Company
Burlington Industries, Inc.
Burroughs Corporation
Bush Brothers & Company
Butler Manufacturing Company

CBI Industries, Inc.
CBS Inc.
CCI Corporation
C/E Construction Company
CF Industries, Inc.
CIGNA Corporation
CSX Corporation
California Casualty Insurance Group
Cameron Iron Works, Inc.
Carlisle Corporation
Carnation Company

Carolina Freight Carriers Corp.
Carpenter Technology Corporation
Carrier Corporation
Casa Grande Valley Newspapers Inc.
Castle & Cooke, Inc.
The Ceco Corporation
Central and South West Services, Inc.
Cessna Aircraft Company
Champion International Corp.
Chart House Inc.
Chemetron Corporation
Chesapeake Corporation
Chesebrough-Pond's Inc.
Chevron U.S.A. Inc.
Chicago Pneumatic Tool Company
Chloride Incorporated
Christie Electric Corp.
Chromalloy American Corporation
Cincinnati, Incorporated
The Cincinnati Mine Machinery Co.
Citibank, N.A.
Cities Service Company
The Citizens & Southern National Bank
City Investing Company
Clark Equipment Company
Clearprint Paper Company, Inc.
Clow Corporation
Coachmen Industries, Inc.
Coastal Corporation
Coats & Clark, Inc.
The Coca-Cola Bottling Co. of N.Y., Inc.
Coca-Cola Bottling Co. of S. Arkansas
Collins & Aikman Corporation
Colt Industries Inc
Columbia Gas System Service Corporation
Columbus McKinnon Corporation
Cominco American Incorporated
Commercial Shearing, Inc.
Commonwealth Edison Co.
Commonwealth Electric Company
Computervision Corp.
Comtel Corporation
ConAgra, Inc.
Concise Casting Corporation
Congoleum Corporation
Connecticut Natural Gas Corp.
Conoco, Inc.
Consolidated Foods Corporation
Consolidated Freightways, Inc.
Consolidated Papers, Inc.
Consumers Power Co.
Consumers Steel Co. Inc.
Container Corporation of America
The Continental Group, Inc.
Continental Illinois Corporation
Continental Machines, Inc.
Continental Telephone Corporation
Cooper Industries, Inc.
Cooper Tire & Rubber Company
The Cornelius Company
Crankshaft Machine Company
Crocker National Bank
Crompton & Knowles Corp.
Crouse-Hinds Company
Crutcher Resources Corp.
Cubic Corp.
Cyclops Corporation
Cyprus Mines Corporation

Dana Corporation
Dart & Kraft, Inc.
Dataproducts Corporation
Daylin, Inc.
Dearborn Rubber Corporation
De Kalb Agresearch, Inc.
De Laval Turbine, Inc.
Delsteel, Inc.
Delta Brick & Tile Company, Inc.
Delta Steamship Lines, Inc.
Deluxe Check Printers, Inc.
Dennison Manufacturing Company
Detroitbank Corporation
Diamond Shamrock Corporation
Dibrell Brothers, Inc.
A. B. Dick Company
Di Giorgio Corporation
Digital Equipment Corp.
Dixie Yarns, Inc.
DoAll Company
Dominion Mortgage & Realty Trust
Donaldson Company, Inc.
R. R. Donnelley & Sons Company
Dorchester Gas Corp.
Dover Corporation
Dresser Industries, Inc.
Dundee Cement Co.
Dynamics Corporation of America

E-Systems, Inc.
EL-GE Potato Chip Co., Inc.
ENTELCO Corporation
Eagle-Picher Industries, Inc.
Earth Resources Company
Eastern Gas and Fuel Associates
Jas. D. Easton, Inc.
Eaton Corporation
Echlin Inc.
Economics Laboratory, Inc.

Edwards Brothers Incorporated
Electronic Memories & Magnetics Corporation
Elgin National Industries, Inc.
The Elk Cotton Mills
Davis H. Elliot Company, Inc.
Eltra Corporation
Emerson Electric Company
Erb Lumber Co.
Erie Castings Company
Esmark, Inc.
Esterline Corporation
Ethyl Corp.
Eubanks Engineering Co.
Evans Products Company
Everett/Charles, Inc.
Ex-Cell-O Corporation

FMC Corporation
FMR Corp.
Fairfield Manufacturing Co., Inc.
Farmland Industries, Inc.
Federal-Mogul
Federal Paper Board Company, Inc.
Federated Department Stores, Inc.
Ferguson Enterprises, Inc.
Fidelity Management & Research Co.
Figgie International Inc.
Finch, Pruyn & Co., Inc.
First American Bank, N.A. Washington
First Bank System Inc.
First Mississippi Corp.
The First National Bank of Chicago
Fischbach Corporation
The Flintkote Company
Florida Rock Industries, Inc.
Fluor Corp.
Ford Motor Company
The Foxboro Company
Franklin Electric Co., Inc.
Friona Industries, Inc.
Fruehauf Corporation
Fruit Growers Express Co.
Fuqua Industries, Inc.
Furnas Electric Company

GK Tecnhnologies Incorporated
GTE Corp.
Gamble-Skogmo, Inc.
Gannett Co., Inc.
Gast Manufacturing Corporation
General Cinema Corporation
General Dynamics Corporation
General Foods Corporation
General Portland Inc.
General Signal Corporation
Genstar Corp.
Getty Oil Company
Giddings & Lewis, Inc.
Gifford-Hill & Company, Inc.
Gilbane Building Co.
Gould Inc.
W. R. Grace & Co.
Grafton Foundry Company
Grand Trunk Rail System Inc.
GrandMet USA, Inc.
Great Northern Nekoosa Corporation
Greenbay Packaging Inc.
Greif Bros. Corporation
Greyhound Leasing and Financial Corp.
S. J. Groves & Sons Company
Grow Group, Inc.
The Guardian Life Insurance Co. of America
Gulf Oil Corporation

H & H Industries, Inc.
Hannaford Bros. Co.
Hardee's Food Systems, Inc.
Harnischfeger Corporation
Harris Corporation
Harris Trust & Savings Bank
Harsco Corporation
Hart Schaffner & Marx
Hayes-Albion Corporation
Walter E. Heller International Corp.
Hershey Foods Corporation
Hesston Corporation
Hewlett-Packard Company
The Higbee Company
Hillyer Corporation
Edward Hines Lumber Company
Homestake Mining Co.
Hospital Corp. of America
Houdaille Industries, Inc.
Harvey Hubbell, Inc.
S. E. Huffman Corp.
Hughes Tool Company
Hurco Manufacturing Co., Inc.
Hyster Company

IC Industries, Inc.
ITT Corp.
IU International Corp.
Iandoli's Super Markets, Inc.
Ideal Basic Industries, Inc.
Illinois Tool Works, Inc.
Inco Electroenergy Corp.
Ingersoll-Rand Company
Inland Steel Company

Intel Corporation
International Business Machines Corporation
International Minerals & Chemicals Corp.
International Multifoods Corp.
International Paper Company
International Proteins Corporation
Internorth, Inc.
Iowa Beef Processors, Inc.
Island Creek Coal Company

JLG Industries, Inc.
James River Corp. of Virginia
Jewel Companies, Inc.
Johns-Manville Corp.
Johnson Controls, Inc.
Johnson & Johnson
Earle M. Jorgensen Co.
Josten's Inc.
Joy Manufacturing Company

Kaiser Cement Corporation
Kaman Corporation
Keebler Company
Kendavis Industries International, Inc.
Kennametal Inc.
Kerr-McGee Corporation
Kingsbury Machine Tool Corporation
Kirsch Company
Kraft, Inc.
Kuhlman Corporation
Kysor Industrial Corp.

The LTV Corporation
Laclede Steel Company
Lakeview Forge Company
F. Jos. Lamb Company
Lampert Lumber Company
Lance, Inc.
Land-O-Lakes, Inc.
Lanier Business Products, Inc.
Laurel Grocery Company, Inc.
Lear Siegler, Inc.
Leaseway Transportation Corp.
K. O. Lee Company
Lehigh Portland Cement Co.
Edw. C. Levy Co.
Lockheed Corporation
Longyear Company
The Louisiana Land and Exploration Co.
Louisiana-Pacific Corporation
Lucky Stores, Inc.
Ludlow Corp.
Lukens Steel Company
Lykes Bros. Inc.

MAPCO Inc.
MBPXL Corporation
MCA Inc.
Macmillan Inc.
Manufacturers Hanover Trust Co.
Marathon Manufacturing Company
Maraton Oil Company
The Marmon Group, Inc.
Marquette Company
Marriott Corp.
Maryland Cup Corporation
Masonite Corporation
Massachusetts Mutual Life Insurance Co.
A. T. Massey Coal Company, Inc.
McCall Oil & Chemical Corporation
McGraw-Edison Company
McJunkin Corporation
McKee Baking Company
McKesson Corp.
McQuay-Perfex Inc.
The Mead Corporation
Medical Mutual of Cleveland, Inc.
Melville Corporation
Memorex Corp.
Menard, Inc.
Merrill Lynch, Pierce, Fenner & Smith Inc.
Mesa Petroleum Company
Michem Incorporated
Michigan General Corporation
Michigan National Corp.
Microdot, Inc.
Midland-Ross Corporation
Milliken & Company
Millipore Corporation
Missouri Public Service Co.
Mitchell Energy & Development Corporation
Modern Industrial Engineering Co.
Modine Manufacturing Company
Mohasco Corporation
Molex Incorporated
Monsanto Company
Moore McCormack Resources, Inc.
Morton Thiokol, Inc.
Motorola, Inc.
Mountain Fuel Supply Company

NCR Corporation
NI Industries, Inc.
NL Industries, Inc.
NVF Company
Nabisco, Inc.
Nalco Chemical Company
National Automatic Tool Company
National Cooperative Refinery Assn.

National Distillers & Chemical Corporation
National Gypsum Company
National Mine Service Company
National Presto Industries, Inc.
National Semiconductor Corp.
National Starch and Chemical Corporation
Newmont Mining Corporation
Nordson Corp.
The North American Coal Corp.
Northwest Industries, Inc.
Northwestern Steel & Wire Co.

Oak Industries, Inc.
Ogden Corp.
Ohio Machinery Co.
Olin Corporation
Otis Elevator Company
Owatonna Tool Company
Owens-Illinois, Inc.
Oxford Industries, Inc.

PPG Industries, Inc.
Pantasote Company
Parker-Hannifin Corp.
The Parker Pen Company
Pay Less Super Markets, Inc.
Peabody International Corporation
Pechiney Ugine Kuhlman Corporation
Pennsylvania Power & Light Company
Pepsico, Inc.
Perkins-Elmer Corporation
Peter Paul, Inc.
Phelps Dodge Corporation
Philbro-Salomon Co.
Philip Morris Incorporated
Phillips Petroleum Company
Piedmont Trust Bank
Pitney-Bowes, Inc.
Pittsburgh-Des Moine Steel Company
Pittsburgh Forgings Company
Pittsburgh & Lake Erie R.R.
The Pittston Company
Pittway Corporation
The Polymer Corporation
Portec Inc.
Porter Paint Co.
Potlatch Corp.
Processed Plastic Company
Public Service Electric and Gas Company
Publix Super Markets, Inc.
Purex Corporation

RSR Corporation
Ramada Inns, Inc.
Ransburg Corporation
Raybestos-Manhattan, Inc.
Red Wing Shoe Company, Inc.
Reeves Brothers, Inc.
Reliance Electric Company
Republic Corporation
R. J. Reynolds Industries, Inc.
Riegel Textile Corp.
Ring Power Corporation
Robertshaw Controls Company
H. H. Robertson Co.
A. H. Robins Company, Inc.
Rochester-Pittsburgh Coal Co.
Rockwell International Corp.
The Roegelein Company
Rogers Corporation
Rohm and Haas Company
Rohr Industries, Inc.
Roper Corporation
Roto-Finish Company
The Rouse Company
Royal Industries
Ruddick Corporation
Russell Company

SPS Technologies, Inc.
Safeguard Industries, Inc.
Safetran Systems Corp.
Safeway Stores, Inc.
St. Joe Minerals Corporation
St. Regis Corporation
Salant Corporation
Santa Anita Operating Company
Santa Fe Industries, Inc.
A. Schulman Inc.
Scientific-Atlanta, Inc.
Scott, Foresman & Company
Scott Paper Company
Scovill Inc.
Sea-Land Corporation
Sea-Land Service, Inc.
Sealed Power Corporation
G. D. Searle & Co.
Sears, Roebuck and Co.
Seattle-First National Bank
Shaw's Supermarkets, Inc.
The Shelby Mutual Insurance Company
The Signal Companies, Inc.
Signode Corp.
SmithKline Beckman Corporation
Snap-on Tools Corporation
Soundesign Corp.
Southern Railway System
Southwest Forest Industries, Inc.

Southwestern Portland Cement Company
Sovran Bank, N.A.
Spang & Co.
Sprague Electric Co.
Stanadyne, Inc.
Standard Brands Incorporated
Standard Oil Company of California
Standard Oil Company (Indiana)
Standard Oil Company (Ohio)
Standard Register Co.
Standard Tool & Mfg. Co.
Standex International Corporation
Stanley Home Products, Inc.
Stanley Works
Stauffer Chemical Company
Steiger Tractor Inc.
Sterling Drug Inc.
J. P. Stevens & Co., Inc.
Storage Technology Corp.
The Stouffer Corporation
Sun Company, Inc.
Sunbeam Corporation
Sundstrand Corporation

TRW, Inc.
Tandy Corp.
Technicon Instruments Corporation
Tecumseh Products Company
A. Teichert & Son, Inc.
Telautograph Corporation
Texaco, Inc.
Texas Commerce Bancshares, Inc.
Texas Eastern Corporation
Texas Industries, Inc.
Texasgulf, Inc.
Thomas & Betts Corporation
Tiger International, Inc.
Time Incorporated
The Times Mirror Company
The Timken Company
Todd Shipyards Corporation
Transamerica Corporation
Transamerica Interway Inc.
Transcontinental Gas Pipe Line Corporation
The Travelers Insurance Companies
Tropicana Products, Inc.
Tyler Corporation
Ty-Miles, Inc.

UAL, Inc.
UOP Inc.
Uarco, Incorporated
Unarco Industries, Inc.
Union Camp Corporation
Union Carbide Corporation
Union Oil Company of California
Union Pacific Corporation
United States Borax & Chemical Corp.
United States Filter Corporation
The United States Shoe Corporation
United States Steel Corp.
U.S. Tobacco Co.
United Telecommunications, Inc.
Universal Leaf Tobacco Co.

V.F. Corporation
VSI Corporation
The Valeron Corporation
Van Dorn Company
Van Pelt Corporation
Varo Inc.
Vollrath Co.
Vulcan Materials Company

Walker Magnetics Group, Inc.
Ward Foods, Inc.
Warner-Lambert Company
Warner & Swasey Company
Wawa, Inc.
Wean United, Inc.
Western Electric Co. Inc.
Western Publishing Company
Westinghouse Electric Corporation
Weyerhaeuser Co.
Wheelabrator-Frye Inc.
Wheels Inc.
Whirlpool Corporation
White Castle System, Inc.
Williamhouse-Regency Inc.
The Williams Companies
Wilsey Bennett Co.
Winn-Dixie Stores, Inc.
Woodward Governor Company
Woolrich Woolen Mills, Inc.
F. W. Woolworth Co.
Wm. Wrigley Jr. Co.
Wylan, Inc.
Wyman-Gordon Co.

Xerox Corporation

Young & Rubicam Inc.

Zapata Corporation
Zimmer Corp.

STATEMENT OF
THE INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA
TO THE
SENATE COMMITTEE ON FINANCE
ON
MAJOR TAX REFORM OPTIONS

The Independent Petroleum Association of America is a national organization composed of some 7,000 independent oil and natural gas producers located in every producing area of the United States. The IPAA, together with the 29 unaffiliated oil and gas associations listed on the cover page, represents virtually all of the independent producers and thousands of royalty owners in the United States. We are grateful for the opportunity to provide comments on the direction of our national tax policy, an area which has broad application and will directly affect our industry and have personal impact upon our members.

During the course of these hearings, the committee has heard much criticism and scant praise of our present method of taxation. The testimony has applied the traditional criteria of simplicity, equity and efficiency, commonly used to examine the desirability of any tax, to point out the failures of our system. While there is unquestionably much to criticize about the method we have employed to fund our government, the short comings of our system should be viewed from a broader perspective.

An objective appraisal of our income tax must be careful not to examine the tax system in a vacuum by merely applying academic standards which only measure its effectiveness as a means of raising revenue. Our current system has never functioned in this manner. Almost from inception it has been viewed as an integral part of government, and therefore not only a revenue source but an efficient vehicle for accomplishing the objectives of government policy.

The relationship between these government policy objectives and the economic standards of a desirable tax somehow seem obscured by the current debate. The problems of the current tax system reflect not only internal trade-offs between the goals of simplicity, equity and efficiency but also significant trade-offs between these goals and desires to accomplish other public purposes. For example, a theoretical ideal tax system should be both simple and equitable. Yet, the conflict between simplicity and equity is so great as to make them nearly mutually exclusive. The vast complexity of the internal revenue code has developed not through some perverse desire to make the law impenetrable to the average American, but through endless legislative compromises in the attempts to achieve greater "fairness."

A great deal of simplicity could be achieved by eliminating distinctions between ordinary income and capital gains yet these distinctions arose to make our system more equitable. Within a system which entailed steeply progressive marginal tax rates it is believed necessary to distinguish between income arising in the ordinary conduct of business from accretions to value which have occurred over an extended period of time. This rationale could of course be eliminated by reducing the progressivity of the tax rates but, again, does that achieve greater or lesser equity. There is no shortage of examples of situations in which our current tax system has sacrificed simplicity in the name of further fairness. In our dynamic political process it is doubtful that any straightforward federal revenue measure could remain simple for any extended period of time. There will be continual "reform" in the search for greater equity. Most of such changes would result, as in the past, from the recognition that is not alike, and that stimulation of particularly critical economic activity can be achieved only by differential tax treatment.

The complexity and inequity of our current method of financing our government do not deserve to be defended. However, any attempt to further "reform" our current revenue system must be viewed with great skepticism. Although the objective is truly laudable, is it possible to have a popular and painless method of financing government acitivities?

With our current tax system comes the greatest academic criticism for its failure to meet the standard of economic efficiency. Since certain forms of savings and certain forms of investment are currently given favorable treatment under the Internal Revenue Code, this favorable tax treatment will affect rates of return from those activities. By significantly impacting the after tax rate of return the tax system functions to allocate resources in a manner different from what would occur if no tax system existed. The resulting change in investment patterns is viewed as distorting the over-all economy. This is of course correct, and far from being unintended it is precisely for this reason that most of the differential provisions were enacted. The role of tax policy in providing incentives to channel private investment in a manner which reflects the goals of public policy has been recognized as a fundamental of taxation since the inception of our income tax.

U.S. tax policy is also being guided by a desire to tax all enterprises in a manner which reflects their unique characteristics. There are numerous examples of specific provisions in the Internal Revenue Code which were enacted in recognition of these principles. Providing deductions for home mortgage interest, charitable contributions, credits for research and development, credits for investment in machinery and equipment, and deductions for intangible drilling costs, were enacted to encourage, respectively, homeownership, philanthropy, fundamental research, expansion of industrial capacity, and development of domestic energy production. Different taxing schemes have also been employed to account for fundamental differences in the nature of such businesses as public utilities, farmer's cooperatives, banks, savings and loan associations, insurance companies, real estate investment trusts, and the list could continue.

These principles likewise influenced the taxation of the petroleum industry from the beginnings of the income tax. Tax incentives for producers have proven to be an efficient vehicle of accomplishing the objectives of government policy. The close relationship between government tax and pricing policy and the industry response has been clearly demonstrated. A statistically significant positive relationship exists between the historical oil and gas tax incentives, the current deduction of intangible drilling costs and the provision for percentage depletion, and the rate of net investment in proved reserves through drilling. The option to deduct intangible drilling costs and the recognition of depletion are not the product of congressional favoritism to a special class of taxpayer. These provisions have endured through seventy years of economic change only because they make good sense. These provisions, although perhaps imperfect, exist in recognition of the need to provide incentives for exploration and development of crude oil and natural gas. It goes without saying that in the absence of the spending thus generated we are simply liquidating our known reserves.

While in concept an ideal tax system might be one which is neutral with respect to all investments it does not necessarily follow that government should be similarly neutral regarding the allocation of its national resources. We believe it is a legitimate function of government to encourage the development of our mineral resources, along with many other forms of activity. Although utilizing the tax system as the means to provide the necessary incentive may make the tax system less "economically efficient," in a theoretical sense, it is nevertheless the most efficient means the government has at its disposal of providing those incentives. And this role must not be forgotten.

Our tax system is far from ideal. The existing high marginal rates continue to stifle economic growth. Compliance with the awesome complexity of the Internal Revenue Code is a burden to productivity. Yet despite these glaring deficiencies we have adapted to the system. Our investors and operators have grown accustomed to and dependent on existing tax incentives to facilitate sufficient capital formation to maintain our reserve of hydrocarbons. While the prospect of a simple tax system is alluring a realistic analysis provides little evidence that it is either attainable or desirable. No simple system can address a society and business structure as complex as that which exists in our ation today and regardless of the simplicity no tax system will remain popular when the time comes to pay.

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April 25, 1984

Senate Finance Subcommittee on
  Oversight of the Internal Revenue Service
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Attention: Roderick A. DeArment, Chief Counsel
Committee on Finance

Re: Hearing to Examine Impact of Federal Income Tax
System on Productivity and Economic Growth

Gentlemen:

I am a lawyer in Seattle, Washington, engaged primarily in a federal tax practice for the last seven years. Much of my practice involves advising clients about income taxes, preparing income tax returns and handling audits and appeals within the IRS.

I have observed a high level of dissatisfaction among clients from all walks of life with the complexity, unfairness and time and resource wasting inefficiency of the progressive rate income tax system. Working class clients have expressed to me a lack of interest in working overtime because the extra income is taxed more heavily than their basic salaries. Entrepreneurs and business clients of mine have limited their income producing activities because taking business risks are not worth it to them if up to half of the additional income is taken by taxation. I am sure billions of dollars each year are wasted paying professionals to do tax returns that laymen should be able to understand, in handling unnecessary tax audits and appeals, and buying unproductive and useless tax shelter investments. None of these activities add anything to our gross national product and produce nothing of real value to anyone.

Senate Finance Subcommittee on
Oversight of the Internal Revenue Service
April 25, 1984
Page Two

The State of Washington has a flat rate business and occupation tax which requires very little administration. Taxpayers understand it, prepare their own returns, feel the system is just and its self-assessment procedure works well. It produces revenue efficiently and fairly, and unlike the progressive rate income tax, does not discourage increased savings, productivity or entrepreneurial risk taking. The flat rate business and occupation tax is backed up with a sales tax, which generally taxes consumption, and therefore promotes individual savings.

I am convinced that our economy will become increasingly stifled under the weight of what now is a completely oppressive graduated income tax system. My strong recommendation is that a 15% flat rate income tax system be adopted, backed up by a national sales tax such as a value added tax.

Sincerely,

Alan L. Montgomery

Alan L. Montgomery

ALM:br
cc: Sen. Slade Gorton
Sen. Daniel Evans
Rep. Joel Pritchard

Written Statement of
John Gray, President
of the
National Asphalt Pavement Association
for Submission to the
Finance Committee
of the
United State Senate

October, 1984

Hearing Topic: Tax Reform
Hearing Dates: September 11 & 20 1984

Mr. Chairman and Members of the Committee:

Thirty years ago I left the United Kingdom to come to the United States. I am now a proud citizen of this country. I left Scotland because I could not watch a once great nation reduce itself from a first-rate power to a tenth -rate power by over-reaching itself economically and by adopting an internal socialist doctrine which embraced an entitlement program that denied the relationship between gross national product, productivity and the quality of life that the nation could afford.

The United States of America, which in its golden years has shared its wealth with most people all over the world and also provided opportunities for its own citizens, appears to me now, however, to be pursuing a similar course to that of the United Kingdom.

I am, therefore, concerned for the ability of this nation to provide the same opportunities to my sons and to their children as were provided to me. I remain equally concerned about this nation being able to defend itself and to represent the free enterprise system and capitalist ideals. I believe, however, that the greatest threat to our system is coming from our internal prodigality, and our apparent inability to deal with the real threat to our system, which is our rapidly expanding national debt, coupled with our significantly negative balance of trade payments.

We hear much conversation about the reduction of the deficit. We hear little conversation about expunging the national debt. It is plain and simple that if we did not have a national debt, there would be little or no deficit (Table I). I offer these comments, therefore, out of a deep concern, not only for America, but most importantly for the heritage which we will be leaving for future generations of Americans, focusing particularly on the problem of our growing national debt, but also to look at an alternate course which could set America on a road to financial stability.

THE PROBLEM

In recent years, the budget deficits and more particularly the increasing national debt of the Federal government have had an increasing impact on the economic health and quality of life of the American people. The national debt (See Table I) has risen from $50.7 billion in 1940 to $1.3 trillion in 1983. At the same time the interest on the debt has risen from $1.0 billion in 1940 to over $128 billion in 1983, our budget deficits have risen as well. As deficit spending continues to grow, it adds to our national debt: as the debt grows it adds to our budget costs and concomitantly to our budget deficits.

Until now most of the public discussion on our economic problems has related to attacking the deficits, on the assumption that a reduction of the deficit rate would help stabilize the finance and investment markets. Although this is probably true, the equilibrium the financial markets would receive would only be temporary and would not solve the real problem - the national debt. As the publicly held national debt grows larger to finance the continuing budget deficits, the interest paid on that debt grows incrementally, creating even larger deficits and adding to that debt. Each rise in the interest rates caused by heavy government borrowing, increases the burden as the Treasury Department must continue borrowing to pay the higher interest rates. For most years since 1940 (see Table I) the interest on the debt has been significantly larger than the budget deficits. If there were no national debt, the national budget would have been balanced and in many years there would have been a surplus.

Impact of the National Debt on the Economy

Traditionally, as Federal budget deficits have occured, the government has had two methods of remaining solvent. One has been to go into the financial markets to borrow the needed funds; or two, to print the needed money. It is our opinion that neither is a viable course for America because of its resultant social and economic impacts on the consumer, producers and ultimately the Federal government.

Federal Borrowing

Continued Federal government borrowing has added to the national debt. As the Federal government has moved to borrow money, many private investors and businesses have been priced out of the money marketplace. During the early 1980's, heavy government borrowing coupled with tight monetary policy placed significant upward pressure on interest rates, pushing the prime lending rate to record levels.

Domestic consumers are affected since borrowing is made more expensive, leading these consumers to delay their purchases of interest sensitive items such as homes and automobiles. As consumers delay these purchases, record business losses and business failures can occur, such we have seen in the automobile and construction industries (see Table III). For its part, government is affected by the loss of tax income from unemployed workers; which, in fact, incur a liability as unemployment increases (see Table II), further adding to the national debt.

Value of the dollar

As interest rates increase, money, especially from foreign investors, flows into high yielding U.S. investments. As this money becomes available, the value of the dollar is enhanced against foreign currencies (see Table IV). This results in significant increases in the strength of the dollar against all foreign currencies. However, this comes at a price, that being a large share of the Federal debt is now held by foreign investors (see Table I). In fact, foreign ownership of the national debt has increased almost 50% since 1979.

As the value of the dollar increases, foreign products become less expensive for the American consumer resulting in a greater demand for foreign-made products. This demand reduces business volume and profitability for many U.S. companies. Increasing numbers of U.S. companies have responded to such pressures by obtaining parts from foreign producers and/or relocating their own manufacturing facilities to overseas locations where materials and labor are less expensive. This results in reduced employment levels for parts of the U.S. labor force and has caused nearly a 100% impact in our balance of trade deficit (see Table V).

Balance of Trade Payments

As foreign money flows into the U.S. to reap the benefits of the high interest rates, it flows out in the form of product sales. As foreign products are purchased, these monies enhance foreign economies rather than the U.S. economy. Since these funds are lost to the U.S. economy there is less capital available for borrowing, putting further upward pressure on interest rates, and making U.S. companies, which must borrow at these high rates, less competitive than their foreign counterparts.

Printing Money

The second option is for the Federal Government to print enough money to cover the deficits, inflating the economy. This approach was used in the late seventies when inflation increased from 6.5% in 1977 to over 13% by 1980.

As the price of goods and services escalate, the U.S. consumers purchasing power is eroded. Some consumers react by placing greater limits on their spending, causing businesses to curtail production to meet this drop in consumer demand. However, many consumers cannot, or will not, limit their spending, and incur significant amounts of debt. This creates a situation where these consumers must borrow increasingly large sums to repay their debts with the currently deflated dollars. This significantly overheats the economy, setting the stage for the tighter monetary policy and high interest rates such as we are currently experiencing.

In the past, the government benefitted from inflation. As salaries escalated, individuals found their earnings pushed into higher tax brackets. However, the government's purchasing power was eroded as the costs the government had to pay also rose at inflationary rates.

Value of the dollar

As the money supply expands, interest rates begin to fall or are held down (see Table III). As interest rates move downward, the dollar, as an investment vehicle, becomes less attractive (see Table IV). Investments, formerly in dollars, move to other currencies and/or other investment vehicles not experiencing the ravages of inflation. As a result, precious metals increase and the dollar drops against all other major currencies.

Balance of Trade Payments

As the dollar declines, it costs more to purchase foreign-made products, creating a greater demand for domestically produced products. This enhances our export market since American-made products can now compete more favorably in foreign markets.

The income from these overseas sales comes to U.S. businesses, and to a degree, begins to offset the loss of domestic sales caused by inflationary pressures. This enhances our balance of trade payments at the cost of domestic sales (see Table V).

As long as America's national debt exists and continues to expand, the Federal government will be forced to borrow to meet its debt service, putting upward pressure on interest rates and increasing its own costs, or printing money and inflating the economy. As we can see in the data of the late seventies and early eighties, neither is an approach we can look upon favorably. A new approach is not only needed but critical for U.S. economic growth.

AN ALTERNATIVE APPROACH:

Any new approach which is offered should include both spending restraints and revenue enhancements in attempting to correct the deficiencies which exist in our current economic environment. It should: 1) Limit federal expenditures to income; 2) Limit the rate of growth of government spending; 3) Provide a simpler and more equitable system of taxation; and 4) Establish a system that will both reduce the deficits and begin reducing the principal of our national debt.

The approach we would offer for your consideration would include: 1) A constitutional amendment for a balanced budget coupled with a moratorium on budget increases for three years, and then limiting the rate at which government spending would be allowed to grow; 2) Modifying the current income tax system; and 3) Establishing a national debt retirement fund financed with a dedicated national sales tax.

Constitutional Amendment for a Balanced Budget

Recently there has been considerable discussion regarding a balanced budget amendment. At the present time, 32 of the 34 states needed have sent their petition to Congress with the required number of signatures. A balanced budget amendment coupled with a moratorium on budget increases for a period of three years, and a limited rate of growth of the budget after this initial period, would begin to lessen the Federal government's dominance in the domestic finance markets, and release increased funds for productive investment in the private sector.

A Modification of the Current Income Tax System

Many taxpayers and tax policy analysts are dissatisfied with the current Federal income tax system, which is perceived as being overly complex and unfair. In a recent study by Cambridge Reports, Inc., only 22% of the people surveyed believed the current income tax system was fair and just. Seventy percent (70%) of the respondents believed the current Federal taxing system was unfair. Americans complain that tax forms are too complicated for the average person to understand, and that there are a wide variety of loopholes causing many wealthy Americans to spend more time looking for ways to avoid paying taxes, than investing their money productively. What is needed is a system of taxation that is much more simplified and creates incentives for economic growth.

Although the fairest and most equitable tax would probably be a flat rate tax, the political realities as well as the economic dislocations that could occur would preclude movement to this concept, at the present time. However, a modified flat tax system, such as those now being considered by the Congress, that could eliminate many of the deductions and loopholes that currently exist while retaining the more popular deductions for a majority of Americans, such as home mortgage interest payments and medical deductions, coupled with incentives for savings may well be a more viable alternative.

A modified flat tax system, for both individuals and corporations, established at the appropriate levels could increase income into the treasury and yet provide renewed incentives for economic growth and an improved way of life for all Americans.

National Debt Retirement Trust Fund

The national debt is projected to expand beyond $1.45 trillion by the end of this year and is escalating rapidly. The interest the government is paying on our national debt continues to increase, becoming a larger and larger share of the Federal budget. In addition, a significant amount of our national debt is held by foreign investors. We have become dependent on this source of funds to the degree that if a significant drop in interest rates occurred, foreign investors would be forced into better yielding currencies causing a shortage in the funds to monetize our national debt. We believe that we have a debt crisis and must move to begin to reduce the national debt and ultimately eliminate it.

We would like to recommend the establishment of a national debt retirement trust fund; funded with a 10% national sales tax (not to be confused with a VAT, value added tax) that would go into the National Debt Retirement Trust Fund and be dedicated solely for the purpose of reducing and ultimately expunging the national debt and would automatically lapse when the debt had been retired.

Current research indicates that a 10% national sales tax would generate $250 billion per year in revenue. Assuming a balanced budget and modest increases in revenues from the 10% sales tax, it would take only five years to retire the national debt. Each year, as portions of the national debt are paid off, the debt service on the debt will be reduced accordingly. The reduced debt service payments will therefore directly result in reduced annual deficits. As the national debt and deficits are reduced, the surplus tax generated monies could be directed into other financially troubled Federal programs or could be used to accelerate the reduction of the debt.

Summary

If the program suggested above were to be adopted, much of the current public concern over the nation's financial status would be resolved. With the national debt paid off, and a mandatory requirement for balanced Federal budgets to preclude future deficits, the Federal government would be largely removed as a competitor to private investors in the nation's financial markets.

Interest rates would be reduced, making housing and other private capital investments more affordable for consumers. Businesses could better afford to invest in capital improvements and modernization of existing plants. The dollar would return to a competitive level in relation to foreign currencies, helping to reduce the current disparities in the U.S. balance of trade. Individuals would have increased incentives for personal savings and would aid in the expansion of capital funding available for the expansion and modernization of the national industrial base.

I am fully conscious of the political and economic downsides of a 10% national sales tax. However, I believe that Americans in general would commit themselves to the acceptance of such a tax if it could assure future Americans a better opportunity to enjoy the fruits of their labor, and not to be burdened by an ever expanding debt incurred by previous generations.

To enact such a program will require considerable fortitude, but leadership displayed by such an action would demonstrate to the world our seriousness in this effort and could have the effect of stabilizing less affluent nations and making them think about living within their own means.

I believe that the majority of Americans would rally to this cause and would greatly respect a leadership that has a commitment to protecting America's future as well as glory in its past.

Table I

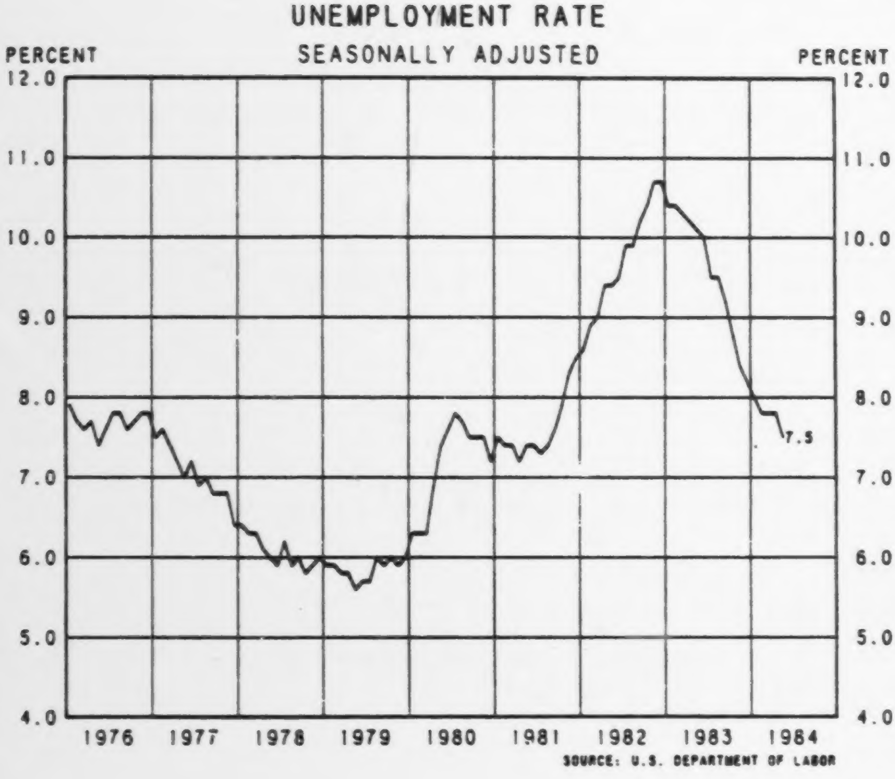
Economic Status of the Federal Government

(All figures in billions of dollars unless otherwise noted)

Year	Receipts	Outlays	Surplus or Deficit	Outstanding Gross Debt	Interest Paid	Interest as a % of Fed. Budget	Foreign Held Federal Debt	
								% of U.S. Gross Debt
1940	9.5	9.5	-3.1	50.7	1.0	11.5%		
1950	39.5	42.6	-3.1	256.9	5.7	14.5		
1960	92.5	92.2	+.3	290.9	9.2	10.0		
1970	192.8	195.7	-2.8	382.6	19.3	9.8	20.3	5.3
1971	187.1	210.2	-23.0	409.5	21.0	9.9	46.7	11.4
1972	207.3	230.7	-23.4	437.3	21.8	9.4	55.5	12.7
1973	230.8	245.6	-14.8	468.4	24.2	9.8	56.0	12.0
1974	263.2	267.9	-4.7	486.2	29.3	10.9	58.8	12.1
1975	279.1	324.2	-45.2	544.1	32.7	10.1	66.8	12.3
1976	298.1	364.5	-66.4	631.9	37.1	10.1	78.0	12.3
1977	355.6	400.5	-44.9	709.1	49.9	10.4	109.1	15.4
1978	399.6	448.4	-48.8	780.4	48.7	10.8	132.1	16.9
1979	463.3	491.0	-27.7	833.8	59.8	12.1	117.9	14.1
1980	517.1	576.7	-59.6	914.3	74.9	12.9	128.4	14.0
1981	599.3	657.2	-57.9	1003.9	95.6	14.5	135.4	13.5
1982	617.8	728.4	-110.6	1134.2	117.4	15.1	148.3	13.1
1983	600.6	795.9	-195.4	1383.7	128.0	15.8	164.8	11.9

Data drawn from the "Statistical Abstract of the United States - 1983", and "Monetary Trends, July 1984", Federal Reserve Bank of St. Louis.

Table II



UNEMPLOYMENT RATE

SEASONALLY ADJUSTED

SOURCE: U.S. DEPARTMENT OF LABOR

Table III

National Economic Statistics

Year	Prime Rate (%)	% change in Consumer Prices	Industrial Production Index (1967=100)	Business Failures
1960	4.82	1.6	66.0	14,177
1965	4.54	1.7	89.8	14,849
1970	7.91	5.9	107.8	10,993
1974	10.81	11.0	129.3	9,915
1975	7.86	9.1	117.8	11,432
1976	6.84	5.8	130.5	9,628
1977	6.83	6.5	138.2	7,919
1978	9.06	7.7	146.1	6,619
1979	12.67	11.3	152.5	7,564
1980	15.27	13.5	147.0	11,742
1981	18.87	10.4	151.0	16,794
1982	14.86	6.1	138.6	N.A.
1983 (Jan-May)	10.73	3.5	141.0	N.A.

N.A. = Data not Available

All Data drawn from the Statistical Abstract of the United States - 1984
Chart #'s 867, 797, 1368 and 896.

Table IV

Foreign Exchange Rates
(in U.S. cents per unit of foreign currency)

Country	Currency Unit	1965	1970	1975	1980	1981	August 1982	August 1983 (approx)	Aug. 30 1984
Belgium	Franc	2.01	2.01	2.73	3.42	2.70	2.11	1.85	1.70
Canada	Dollar	92.74	95.80	98.30	85.53	83.41	80.30	80.90	76.97
France	Franc	20.40	18.09	23.35	23.69	18.49	14.43	12.30	11.32
W. Germany	Mark	25.40	27.42	40.73	55.09	44.36	40.30	37.60	34.76
Italy	Lira	.16	.16	.15	.12	.09	.07	.06	.05
Japan	Yen	.28	.28	.34	.44	.45	.39	.41	.41
Netherlands	Guilder	27.77	27.65	39.63	50.37	40.19	36.64	33.80	30.80
Sweden	Krona	19.39	19.28	24.14	23.65	19.86	16.28	12.80	12.05
Switzerland	Franc	23.11	23.20	38.74	59.70	51.03	47.35	46.50	41.87
United Kingdom	Pound	279.59	239.59	222.16	232.58	202.43	172.50	159.00	131.50

Data drawn from the "Statistical Abstract of the United States - 1983", and "International Economic Conditions - August 1984", Fed. Reserve Bank of St. Louis

Table V

United States Balance of Trade

Year	IMPORTS	EXPORTS	Trade Balance Surplus(+)/Deficit(-) (Millions of Dollars)	EX/IM Ratio
	(IN MILLIONS OF DOLLARS) (> = annual change in %)			
1965	21,510	26,461	+4,951	23.00
	> 18.51	> 10.76		
1966	25,493	29,310	+3,817	14.97
	> 5.38	> 4.62		
1967	26,866	30,660	+3,800	14.14
	> 22.79	> 9.65		
1968	32,911	33,626	+635	1.92
	> 6.35	> 8.29		
1969	35,807	36,414	+607	1.69
	> 8.54	> 16.62		
1970	39,866	42,469	+2,603	6.52
	> 14.33	> 2.00		
1971	45,579	43,319	-2,260	(-5.21)
	> 22.41	> 12.99		
1972	55,797	49,381	-6,416	(-12.99)
	> 26.34	> 44.61		
1973	70,449	71,410	+911	1.29
	> 47.25	> 37.66		
1974	103,811	98,306	-5,505	(-5.59)
	>(-5.73)	> 8.93		
1975	98,185	107,088	+8,903	9.06
	> 26.52	> 7.15		
1976	124,288	114,745	-9,483	(-8.26)
	> 22.28	> 4.74		
1977	151,907	120,186	-31,721	(-26.39)
	> 15.87	> 18.19		
1978	176,020	142,054	-33,966	(-23.91)
	> 20.45	> 29.86		
1979	212,028	184,473	-27,555	(-14.93)
	> 17.80	> 21.55		
1980	249,781	224,237	-25,544	(-11.39)
	> 6.12	> 5.70		
1981	265,086	237,019	-28,067	(-11.84)
	>(-7.05)	>(-12.21)		
1982	247,606	211,217	-36,389	(-17.22)
	> 5.30	> (-5.50)		
1983	260,753	200,203	-60,550	(-30.24)

Data from the Department of Commerce

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STATEMENT ON TAX REFORM PROPOSALS TO THE SENATE FINANCE COMMITTEE

Hearings on Major Tax Reform Options

September 11 and 20, 1984

STATEMENT OF
MUTUAL OF AMERICA LIFE INSURANCE COMPANY
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PRESIDENT

STATEMENT ON TAX REFORM PROPOSALS TO THE SENATE FINANCE COMMITTEE

This statement is submitted on behalf of Mutual of America Life Insurance Company, a tax-exempt, non-profit corporation which is limited by its Charter to underwriting employee benefit plans for non-profit health and welfare agencies. Mutual of America's predecessor, National Health & Welfare Retirement Association, was founded in January 1945 under New York law. Its chief purpose was to provide retirement benefits to those in the health and welfare industry. Mutual of America's founding fathers, who were primarily volunteers and executives of the predecessors to United Ways and their supported organizations, sought to provide employee benefit programs for the professionals and staff members of such agencies. On January 1, 1984, the name was changed to Mutual of America.

Today, Mutual of America is licensed in the District of Columbia and 43 states. Regional Mutual of America field offices have been opened in key cities across the country and in the home office in New York City. At the end of 1983, Mutual of America was underwriting 20,700 employee benefit plans for approximately 3500 non-profit health and welfare organizations and Mutual of America-insured pension plans covered close to 250,000 employees. The Company's policyholders include many of the Nation's prominent publicly-supported charitable organizations such as the United Ways in numerous communities, the Girl Scouts of America, Goodwill Industries, the Council of Jewish Federations, Association of Junior Leagues and other hospital, philanthropic and charitable organizations. Mutual of America's Board of Directors includes many officials of charitable agencies in the health and welfare field, including the United Way, the Girl Scouts and others.

Pension plans of charitable organizations insured by Mutual Of America include both defined benefit and defined contribution plans. In general, the pension plans of Mutual of America's policyholders are small, with twenty or fewer participants.

While Mutual of America has grown since its inception in 1945 into a large insurance company with many policyholders, its focus has not changed over the years. Although the Company's policyholders are tax-exempt because of their charitable nature, many of the pension plans they have established are tax-qualified under Code Section 401(a), which ensures the right of covered employees to treat pension benefits under these plans as non-taxable until received upon retirement. For this reason, the policyholders have a strong interest in the impact of changes in the tax code that affect employee benefit plans generally as well as those that affect plans of non-profit organizations in particular.

We intend to address, in this brief statement, the importance of retaining the current favorable tax treatment accorded to pension plans generally and the Section 403(b) benefit arrangements for employees of non-profit organizations in particular. We will also discuss the status of charitable contributions under a revised tax system. While these issues have been addressed in oral testimony presented to this

Committee, we believe that we can provide a unique perspective on these topics because of our role as a provider of employee benefits to the non-profit health and welfare community.

Employee Benefits

The importance of pension plans to today's workforce cannot be overstated. At the end of 1982, according to Department of Commerce estimates, employer contributions for retirement plans totaled 9% of employee compensation, contributions for health insurance accounted for approximately 4.4% of total compensation and payments for unemployment, workmen's compensation and life insurance totaled 2.4% of compensation. While fringe benefits receive much publicity, they are estimated by the Chamber of Commerce to account for only 0.6% of total compensation.

Thus, by far the most significant type of employee benefit plan is provision for retirement benefits. Of the millions of employees covered by pension plans, a significant portion are from the non-profit community. Together with the Social Security system, private pension plans have become a critical element of retirement security for non-profit employees and for American workers generally.

Employees of many non-profit organizations have a special interest in the tax incentives for retirement benefits. Employees such as those of Mutual of America's policyholders tend to be less well paid than their counterparts in the commercial sector. Salaries are rising, albeit slowly, among non-profit employees, but the effects of years of low compensation continue to be felt with respect to planning for retirement by those employees who have been in the non-profit sector for a number of years. With very few exceptions, our policyholders simply cannot afford to offer the high-paying positions in which deferred compensation plans can make up for earlier low retirement savings. (And thus, of course, these are not the plans likely to be of a kind from which arise perceptions of abuse.) Nevertheless, these retirement programs are an important incentive for our policyholders to encourage qualified applicants to accept lower paying jobs in the health and welfare sector. This is particularly the case because non-profit employers cannot, as in the business sector, offer incentives such as stock purchase or option plans.

Moreover, as tax exempt entities, Mutual of America's policyholders have a particularly significant interest in maintaining the current tax-exempt or tax-deferred treatment of employer benefits to their employees. Because these non-profit employers are not concerned with the deductibility of contributions to benefit plans on their own tax returns, the tax treatment of these benefits to the employees becomes more important than it is to tax-paying employers. In fact, the tax treatment of employee benefits to their employees is the primary incentive for our policyholders to offer employee benefit programs. To the extent this treatment is reduced or restricted, the level of contributions by Mutual of America's policyholders would be likely to drop even more sharply than it would generally in the business community. Thus, the employees and agencies with whom we are concerned represent the group most likely to be severely affected by any changes in the tax treatment of employee benefit plans.

Many of these employee benefit plans for health and welfare organizations were established under Section 403(b) of the tax code, which provides for tax-sheltered annuity benefits for employees of eligible non-profit organizations. We believe that because of the special significance of incentives for non-profit employees this provision should be preserved in any forthcoming legislation.

Indeed, it should be noted, Section 403(b) and Section 415(c) (which sets limits on how much can be sheltered under Section 403(b)) currently provide more generous treatment for employees of hospitals, educational institutions, home health agencies and (as a result of TEFRA) for church and church-related organization employees than it does for employees of health and welfare organizations. Accordingly, if anything, these sections of the code should be made more inclusive. The exclusion of health and welfare employees from these tax shelter benefits has no rational basis and puts secular health and welfare agencies and their employees at a significant disadvantage in terms of compensation as compared to church-related organization and their employees performing similar functions, as well as to similar employees in hospitals, educational institutions and home health agencies.

These benefits which are denied health and welfare organization employees help to mitigate the impact of years of very low compensation for workers in the selected non-profit fields. This is a need which health and welfare employees have as least as much as employees in those other fields. Accordingly, while we favor preserving the tax benefits accorded to non-profit employees under Section 403(b), we also urge that the special treatment now offered to some non-profit organizations be extended to all health and welfare organizations.

We also urge that, in analyzing and refining the "flat tax" proposal of Congressman Kemp and Senator Kasten and the similar proposal submitted by Congressman Gephardt and Senator Bradley, emphasis must be placed on whether deductions and tax-deferred treatment will continue to apply to employee benefit programs generally. As currently drafted, these proposals would make certain employee benefits taxable and would reduce Section 415 retirement amounts. While a major goal of the flat tax proposals is to simplify an overly complex tax code that currently offers too many deductions, we urge the Committee to keep in mind the special needs of America's workforce and the evidence that reliance on individually funded plans such as IRA's has not been effective for workers whose disposable incomes are relatively low.

It should also be remembered that a substantial portion of any revenues saved by eliminating tax preferences for employee benefits could well be offset by increased demands on the nation's social services, including Medicare, Medicaid, welfare and other relief programs. America's workers are, to an increasing extent, reliant on employee benefits. To the extent that the tax treatment of such benefits is rendered less favorable, there is bound to be some decline in benefits offered by employers and some increase in reliance on publicly-funded programs.

Undoubtedly, there are flaws in the present private system of employee benefits. Vesting standards, for example, vary widely employer by employer. However, some employers, including most of our policyholders, offer programs with early vesting standards and flexible portability from one Mutual of America-insured employer to another. It would be unfair and unwarranted to eliminate the beneficial treatment accorded to all employee benefit plans because of problems encountered in a fraction of such plans. To the extent that problem areas exist, they should be addressed directly to improve the system. However, incentives for the programs that do serve the functions Congress intended, as we believe those offered by Mutual of America's policyholders in large measure do, should be preserved and strengthened in any forthcoming legislation.

In short, the current favorable tax treatment of employee benefits should be incorporated into any tax reform legislation to be considered by the Committee. Tax laws favoring employer retirement plans and other statutory employee benefits were enacted under the premise that extensive coverage under such plans is desirable social policy. The growth of coverage under these plans has been encouraged by the tax laws and by the need of working Americans for economic security. Today, while they can be improved, employee benefits are a mainstay of economic security for a major portion of the American workforce. Mutual of America's policyholders, as tax-exempt employers which are unable to offer high salaries or glamorous fringe benefits, have a particularly urgent need to preserve the favorable tax treatment currently offered to employees covered by employee benefit plans.

Charitable Contributions

The other area of prime concern to Mutual of America and its policyholders is the treatment of charitable contributions in tax reform legislation. As health and welfare organizations, Mutual of America's policyholders, in particular, rely significantly on charitable contributions for their funding. At the present time, the tax code provides significant incentives to charitable contributions by making such contributions deductible for purposes of calculating tax liability. To the extent this deductibility is limited, contributions to non-profit organizations are likely to decline. This decline could threaten the existence of many of our policyholders.

When considering this issue, it should be remembered that the social service organizations insured by Mutual of America perform a vital role in American society. These organizations become even more important as various government programs are cut back in the continuing effort to reduce federal spending.

As currently drafted, the Kemp-Kasten and Bradley-Gephardt flat tax proposals retain deductions for charitable contributions. Under the Bradley-Gephardt proposal, however, deductions would only offset income taxed at the 14% level. In other words, regardless of a taxpayer's marginal tax bracket, the tax benefit of a charitable contribution would be 14 cents for every dollar deductions. This could have an impact on giving among high income taxpayers. Even worse, the pure flat income tax approach also under consideration would exclude all deductions entirely, regardless of their merit.

Although this point has been reiterated again and again in the Statements submitted to this Committee, because of our vital interest in the non-profit community, we feel that it bears repeating. To ensure the continued existence of non-profit organizations and the services they provide, the deductibility of charitable contributions must be maintained.

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It is clear that the time for broad tax reform has arrived. There is certainly much room for improvement in our current system, both because of its unwieldy complexity and because of the perceived and actual unfairness of many of the tax loopholes that are now available. The temptation to make sweeping changes in the current system is strong. It must be remembered, however, that the tax code is not only a means of raising revenue, but also a way of implementing social policy. Without incentives built into the tax code, money for many beneficial purposes would no longer be available. Our concerns may be dismissed by some as those of just one more special interest. We contend that voluntary organizations are a unique

American institution. By definition, government cannot do for citizens what they do for themselves through voluntarism. Congress has, and has demonstrated in the past, a special responsibility to encourage the continuation and growth of this vital institution. Accordingly, we urge this Committee to ensure that the important social goals of providing employer security and protecting charitable institutions are not abandoned in the process of reform.

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